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IN THE

Supreme Court of the United States

OCTOBER TERM, 1947.

No. 572

PRUDENCE REALIZATION CORPORATION,
Petitioner,

v.

GEORGE E. EDDY, *et al.*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

The petitioner Prudence Realization Corporation respectfully prays that a writ of certiorari issue to review the order and judgment of the United States Circuit Court of Appeals for the Second Circuit entered in the above cause on December 8, 1947, reversing four orders of the Bankruptcy Court relating to the distribution of collateral securing bonds modified by plans of reorganization confirmed in 1938.

Opinions Below.

The opinion of the Circuit Court of Appeals for the Second Circuit is not yet reported but is printed in the Record at pages 614-623.

The opinions of the District Court are unreported but are printed at R. 22-27, 479.

The Report of the Special Master is also unreported but is printed at R. 28-72.

Jurisdiction.

The decree of the Circuit Court of Appeals was entered on December 8, 1947 (R. 623). Petitions for rehearing filed in that Court by the petitioner and by Reconstruction Finance Corporation were denied on January 5, 1948 (R. 650). The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended, 28 U. S. C., Sec. 347(a), and Section 24(c) of the Bankruptcy Act, as amended, 11 U. S. C. Sec. 47(c).

Questions.[1]

1. Would the plans of reorganization here involved violate Section 77B of the Bankruptcy Act if the holders of Publicly-Held Bonds, as lienors upon the collateral, did not retain unimpaired their claim to full interest at the original rates borne by the bonds.

2. Was the order directing the transfer of the property dealt with by the confirmed Plans and approving the Supplemental Trust Agreement, from which no appeal was taken, *res judicata* on all matters determined thereby which were involved in the decision of the Court below.

3. Was such order required to be given final and conclusive effect on the appeals before the Court below.

4. Was the Bankruptcy Court without power to make such order if it was in error in decreeing therein that

[1] An additional question which will be urged in the argument on the merits is whether or not the court erred in failing to apply the provisions of sec. 77B(h) of the Bankruptcy Act.

changes from the Plans, contained in the Supplemental Trust Agreement, were not materially adverse to the interests of bondholders.

5. Were the provisions of such order and of the Supplemental Trust Agreement properly applied by the Court below.

6. Does a Bankruptcy Court's earlier ruling that changes from a confirmed Plan, contained in a trust agreement approved by such Court to carry out the Plan, are not materially adverse to the interests of creditors, require that such trust agreement, on an appeal from a later order, be interpreted so as to conform to the Plan as construed by the appellate court on such appeal, where such interpretation conflicts with provisions of the trust agreement and the construction of the Plan by the appellate court is in conflict with that of the Judge who made the earlier ruling and who also made the order appealed from.

Statute Involved.

The pertinent provisions of the Bankruptcy Act, as amended, are found in Appendix A, *infra*, pages 20 to 24.

Statement.

In proceedings for the reorganization of Prudence-Bonds Corporation under Section 77B of the Bankruptcy Act, the Plan of Reorganization was confirmed in 1938 (R. 114).

The Plan of Reorganization.

Under the Plan, the Debtor having been found to be insolvent (R. 110), a new corporation owned beneficially by the bondholders, was set up in 1938, and has been operating

since that time (R. 566). This Corporation was also named Prudence-Bonds Corporation (R. 566) and is herein called the "New Corporation".

Under the Plan there were reorganized 18 Series of secured bonds of the Debtor[2] (R. 114-115), aggregating approximately $56,000,000, and held by approximately 30,000 persons (R. 109). Approximately $41,000,000 principal amount of these bonds have heretofore been retired under the Plan and Supplemental Trust Agreement securing them, as such documents were construed by the Bankruptcy Court in 1938, leaving outstanding approximately $15,000,000, including $1,910,300 of subordinated bonds (R. 450-476. See also Appendix B hereto).

Each Series of bonds continued to be secured by its own collateral, under a separate Supplemental Trust Agreement.[3] Maturity of the bonds was extended to 1945, or conditionally to 1950 (R. 164), and on liquidation, if the collateral of any Series was more than sufficient to cover the bonds of that Series, the excess was to be applied toward the payment of bonds of other Series (R. 155). At the time the Plan was confirmed, the collateral in each Series was worth less than the amount due on the bonds in the respective Series (R. 110), and there was no way of ascertaining how much the collateral in any Series would ultimately bring on liquidation. The purpose of this pro-

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[2] Actually, here there was a separate plan for each Series, all substantially identical, integrated with a general plan covering all Series. In this statement all of these plans have been referred to as the "Plan". The separate plan for the Fifth Series appears at R. 163-184 and the Amended General Plan appears at R. 149-161.

[3] As the Supplemental Trust Agreements for the separate Series are substantially identical, they are here referred to as the "Supplemental Trust Agreement". The one covering the Fifth Series appears at R. 315-406.

vision for the reciprocal exchange of surplus collateral among the 18 Series was to afford a greater opportunity to bondholders of all Series to recover their investment; the Series which turned out to be good could help the poorer ones (R. 261-262).

The Debtor's property was transferred to the New Corporation free and clear of all claims except the claims of the holders of the bonds as modified (R. 44-46, 117). The net income of the New Corporation, as distinguished from the net income on the collateral, was applicable *pro rata* to retire bonds of all Series (R. 366), and the New Corporation assumed payment of the principal (R. 154, 325) and interest on the bonds as modified (R. 164, 325, 336, 337, 359).

Admittedly, as against the New Corporation, the old bonds became Income Bonds, i.e., they were entitled to 5½% interest, but only to the extent that the interest was earned by the collateral. The plan nowhere mentioned any further or additional interest and no mention of any lien therefor was made in the order confirming the Plan or in the order directing the transfer of the property dealt with by the Plan. No appeals were taken from either of these orders.

The Court of Appeals held here, however, that as lienors against the collateral, the bonds were not converted to income bonds, but retained unimpaired their claim to full interest. It is our contention that this decision flowed from erroneous conclusions of law and should be reviewed here.[4]

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[4] The decision frankly indicates the belief of the Court of Appeals that the decision was compelled by what we shall demonstrate to be erroneous concepts of the bankruptcy law, i.e., (1) that the Plan here involved would be illegal unless it provided that the Publicly-Held Bonds, as lienors upon the collateral, retained unimpaired their claim to full interest at the original rates borne by the bonds (R. 617-18); (2) that the Bankruptcy Court was without power to make the order approving the Supplemental Trust Agreement unless such agreement provided that the priority of the Publicly-Held Bonds still included the right to recover full

Dispute as to Guarantor's Bonds.

The bonds had been guaranteed by Petitioner's predecessor (R. 109). Petitioner owns an aggregate of $1,910,300 face amount of bonds of the various Series (R. 111), the remainder being publicly held (R. 110).

In the course of the reorganization, a dispute arose as to whether the bonds owned by the guarantor, petitioner's predecessor, should share equally with the publicly held bonds. The Plan reserved this dispute by providing with respect to the bonds in each series owned by the guarantor that if, as a matter of law, such bonds were "in respect of the right to participate in the proceeds of the Collateral" subordinate to Publicly-Held Bonds, they should not in each particular series be the subject "of purchase, retirement or redemption under the provisions of the Retirement Fund, nor be entitled to receive any distributions on account of principal until all of the Publicly-Held Bonds have been fully paid, redeemed, purchased or retired," and further that such bonds "shall be entitled to receive such subordinate treatment in respect of interest to which they may be legally entitled" (R. 178-179).

After the Plan had been recommended for approval by the Special Master, the District Court decreed that the bonds owned by Petitioner's predecessor, the guarantor, should be subordinated in each Series to the Publicly-Held Bonds of that Series, *i.e.*, they were not entitled to payment

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interest at the original rates, before any payment on junior liens; (R. 621), and (3) that the provisions of the order of the Bankruptcy Court in approving the Supplemental Trust Agreement, that changes from the Plans contained therein were not "materially adverse" to creditors, required it now to interpret the Agreement so as to conform to the construction of the Plans now made by the Circuit Court of Appeals (R. 621-23).

until the Publicly-Held Bonds of the particular Series were "paid or provided for in full, both as to principal and interest, heretofore accrued or hereafter accruing" (R. 32-34). While Petitioner's appeal from this decision was pending, this and other disputes between the Publicly-Held Bonds and the guarantor were compromised (R. 34). On such compromise, the guarantor agreed to accept, in each Series, subordination of its bonds in such Series as defined in the decree of the District Court and in the Plan. The guarantor also withdrew approximately $9,000,000 of other claims, and consented to the dismissal of the aforesaid appeal. On this compromise the guarantor received $150,000[5] (R. 34, 250).

The Supplemental Trust Agreement.

In consummation of the Plan, the Supplemental Trust Agreement was executed in 1938 (R. 315, 396, 397). In approving this Agreement as complying with the Plan, the Bankruptcy Court found that any changes from the confirmed Plan, contained therein, were not materially adverse to bondholders (R. 664). No appeal was taken from this order.

The Supplemental Trust Agreements provided that on maturity, any right to back interest not earned would be void and of no effect; and that the subordinated bonds should not receive principal or interest until the Publicly-

[5] The claims of the public bondholders against the Guarantor upon its guaranty were in no way impaired or released by this compromise or by the Plan. Those claims were allowed in full and reorganized in the Guarantor's own reorganization proceeding, and the bondholders have heretofore received and will hereafter receive dividends on those claims (R. 188-189). Indeed, a substantial part of anything recovered on the Subordinated Bonds or any other asset of the Guarantor will go to the bondholders as dividends on their claims under the guaranty. The petitioner represents over 30,000 creditors of the Guarantor whose interests are adversely affected by the decision of the Court of Appeals.

Held Bonds have been "fully paid, purchased or retired by the Corporation." In another place the Agreement provided that the petitioner's bonds "shall not be entitled to share in the Collateral until all other Bonds have been paid or provided for in full according to their tenor" (R. 337-338). The word "Bonds" is defined in the Agreement to mean the bonds as modified by the Plans and the Agreement (R. 323). The Agreement also provided that, in the event of default and sale of the collateral by the Trustee, the net proceeds in each Series after payment of the principal of the Publicly-Held Bonds of the Series, should be applied to the payment of the principal of the subordinated bonds of that Series, with any balance distributable among the other Series (R. 373).

The Present Litigation.

In the case of the Fifth Series of the bonds, the earnings of the collateral have been insufficient to pay the full 5½% interest annually, and, in accordance with the Plan of Reorganization and the Supplemental Trust Agreement, only such interest as was earned was paid (R. 53). The collateral, however, as liquidated, is more than sufficient to pay the principal of the Publicly-Held Bonds (R. 69). It was the contention of the holders of Publicly Owned Bonds in the Fifth Series that even though the arrearages of interest are not due and payable from the New Corporation, they are, nevertheless, a lien upon and may be collected out of the surplus collateral, prior to the payment of the subordinated bonds in the Series, and prior to the application of the remaining surplus [illegible] other Series of bonds. If this lien is permitted, there [illegible] insufficient funds even to satisfy the lien (R. 69).[6]

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[6] The same controversy arose as to several other Series and is involved here.

The Special Master and the District Judge (both of whom had previously passed upon all phases of the reorganization) held that the bonds as modified were Income Bonds on which interest was payable only out of net income on the collateral securing the bonds. The District Court ordered that all net income on the collateral should be paid as interest on the Publicly-Held Modified Bonds in the respective Series; that the principal of the collateral in each Series should first be applied to the payment of the principal of the Publicly-Held Bonds in such Series; and that any surplus collateral remaining after payment of the principal of the Publicly-Held Bonds should be applied to the payment of the principal of the subordinated bonds, and then to the payment of the principal of the other Series of bonds.

The Court of Appeals reversed, holding, first, that as a matter of law the plan of reorganization could not legally deprive the Publicly-Held Bonds, as senior creditors, of their right to a lien upon the collateral for the full amount of the fixed interest to the extended date of maturity, at the rates originally borne by the bonds; second, that therefore the Plan of Reorganization must be construed so as to preserve the lien of the bonds upon the collateral owned by the New Corporation for such arrearages of interest, even though such arrearages were not an obligation of the New Corporation; and third, that for the same reason the Supplemental Trust Agreement must be interpreted as reaching the same result notwithstanding it "looks the other way" and notwithstanding a literal reading of the provisions thereof make it "hard to resist the construction that, after the New Company had discharged its individual promise, the Guarantor's Bonds were to begin to take" (R. 620).

It is our contention that the Court of Appeals has demonstrably erred on each of these grounds; that its

decision is based upon the erroneous fundamental premise that the Plan of Reorganization would be illegal unless it preserved the full lien for interest; that this fundamental error led the Court of Appeals to ignore the plain language of the Plan and of the Agreement and to refuse to apply a construction of these documents made nine years ago by the same Judge who made the orders which the Court of Appeals has now reversed.

We contend that the decision of the Court of Appeals, because of these errors, conflicts with decisions of this Court and of other Circuit Courts of Appeals.

Specification of Errors to Be Urged.

The Court below erred

(1) in holding that the owners of Publicly-Held Bonds, as lienors upon the collateral, retained unimpaired their claim to full interest at the original rates borne by the bonds;

(2) in holding that the Plans, unless so construed, would be illegal;

(3) in failing to hold that the owners of Publicly-Held Bonds, as lienors, were as much limited, with respect to interest, to the income from the collateral as they were as obligees of the New Corporation;

(4) in holding that the Bankruptcy Court was without power to make the order approving the Supplemental Trust Agreement unless such Agreement is interpreted to mean that the priority of the Publicly-Held Bonds still included the right to recover full interest at the original rates, before any payment on junior liens;

(5) in basing its decision on the assumption that the order approving the Supplemental Trust Agreement could

be collaterally attacked if the Bankruptcy Court had erred in decreeing therein that changes from the Plans contained in the Supplemental Trust Agreement were not materially adverse to the interests of bondholders;

(6) in holding that the ruling, made by the Bankruptcy Court in 1938, that changes from the confirmed Plans contained in the Supplemental Trust Agreement, approved by such Court to carry out the Plans, were not materially adverse to the interests of bondholders, requires such Agreement now to be interpreted so as to conform to the Plans as presently construed by the Court of Appeals, despite the fact that such interpretation is in conflict with the Agreement itself and that the present construction of the Plans by the Court of Appeals is in conflict with that of the Bankruptcy Court Judge who made the earlier ruling, and who also made the orders reversed by the decision of the Court of Appeals;

(7) in failing to hold that the order directing the transfer of the property dealt with by the Plans and approving the Supplemental Trust Agreement was *res judicata* on the questions involved in its decision;

(8) in failing to give final and conclusive effect on the appeals before it, to the provisions of the order directing the transfer of the property dealt with by the Plans and approving the Supplemental Trust Agreement;

(9) in failing to apply Section 77B(h) of the Bankruptcy Act.

Reasons for Granting the Writ.

1. The fundamental premise of the Court of Appeals here was that it would have been illegal for the Plan of Reorganization and the Supplemental Trust Agreement to

take from the Publicly-Held Bonds their full lien upon the collateral for interest, whether earned or unearned. This conclusion, which led the Court to strain to reach a contrary construction of the Plan and Agreement, conflicts with the principles of *Case* v. *Los Angeles Lumber Co.*, 308 U. S. 106, 130; *Consolidated Rock Co.* v. *DuBois*, 312 U. S. 510, 528-529; and *Group of Investors* v. *Milwaukee R. Co.*, 318 U. S. 523, 563.

It is true that senior creditors ordinarily must be paid in full before junior creditors may take anything. But the Court of Appeals failed to apply two corollaries to this rule, which are recognized by the cases just cited and which would permit the surrender by the Publicly-Held Bonds of their lien upon the collateral for interest not earned by it:

(a) If the senior position of a creditor is disputed, the controversy may be compromised by assigning the alleged senior creditor less than full seniority. *Case* v. *Los Angeles Lumber Co., supra.* That was the situation here. The Publicly-Held Bonds were not adjudicated to be superior to petitioner's bonds by a court of final jurisdiction, but attained that position as a result of a compromise not only of the controverted issue of priority, but also of other disputes (including the surrender by petitioner of approximately $9,000,000 in claims against the debtor). Hence the degree of priority of the Publicly-Held Bonds was not required to be, as the Court of Appeals thought, the full extent of their claim. And a fair construction of the Plan, uninfluenced by this erroneous belief, must lead to a contrary result, as hereinafter demonstrated.

(b) The lien of a secured creditor may be cancelled or transferred, provided the creditor receives compensation for his sacrifice. *Group of Investors* v. *Milwaukee R. Co., supra.* This consideration also was present here. The emphasis in the

> Plan was upon conserving principal and securing as great a return of principal as possible. Accordingly, each Series of Bonds gave up its right to fixed interest and became income bonds. As compensation, the bonds secured, first, the right to share in the surplus collateral of each of the other Series over what was necessary to pay the principal and earned interest of that Series; second, the right to share in the income of the New Corporation (apart from the income of the collateral); and third, beneficial ownership of the stock of the New Corporation. Therefore, since the Publicly-Held Bonds received this compensation, they could legally, and did, give up their right to a lien for fixed interest.

Thus, the decision here is in conflict with the authoritative rulings of this Court, just cited, since the decision prevents the Plan from having modified the interest rights of the Publicly-Held Bonds in a manner which was intended and which those cases permit.

2. The erroneous premise of the Court of Appeals that it was illegal to take away the full lien for interest of the Publicly-Held Bonds led the Court to ignore the plain language of the Plan and of the Agreement, and to amend them in material respects some nine years after they were confirmed and approved by the District Court. The decision, in this disregard for settled principles of *res judicata*, conflicts with the decisions of this Court in *Stoll* v. *Gottlieb*, 305 U. S. 165; *Chicot County Drainage District* v. *Baxter*, 308 U. S. 371; *Prudence Realization Corp.* v. *Ferris*, 323 U. S. 650, 654-655; *Duggan* v. *Sansberry*, 327 U. S. 499, and with the decisions of other Circuit Courts of Appeals in *In re Diversey Building Corp.*, 148 F. (2d) 65 (C. C. A. 7); *In re Irving Austin Bldg. Corp.*, 96 F. (2d) 905 (C. C. A.

7); *In re Higbee Company,* F. (2d) , C. C. H. Bankruptcy Law Reports, ¶56,016, decided December 2, 1947 (C. C. A. 6).

The Court of Appeals reached the anomalous result that the Publicly-Held Bonds were income bonds as to the New Corporation, but entitled to a lien for their full interest as to the collateral owned by the New Corporation. At R. 618-19 the Court considered what purposes this disparity could serve. It will be noted that this discussion is couched in terms of sheer speculation,—and the record itself shows these purposes to be erroneous.[7]

The Court of Appeals sought to support its conclusion that under the Plan the bonds retained their lien as to all interest by reference to language that the subordinated bonds should receive nothing until the Publicly-Held Bonds were "fully paid". But paragraph 3 of the Plan (R. 164)

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[7] A supposed purpose, as stated by the Court of Appeals, was

> "The due date of each series was 1945, but in each a majority of the Publicly-Held Bonds, if they wished, might extend the maturity to 1950; and it was possible that some of the series might do so, and some might not. If the New Company were to be liable for any deficiency in interest upon the Publicly-Held Bonds in a series which became due in 1945, the bondholders in that series would be able to take judgment and execution against it, and that would, or at least it might, put an end to any further efforts to conserve the collateral of those series which were to last five years longer" (R. 619).

If any such purpose existed, the Special Master and the District Judge, both of whom have participated in this reorganization since its inception, surely would have been aware of it, and hardly could have reached their decision that these were income bonds as to their lien as well as to the New Corporation.

But such a purpose could not exist. The Court mistakenly relied on only one (R. 164) of two pertinent provisions relating to the extension of the bonds. The other provided that if all Series did not agree to extend, the bonds of all Series which had extended would mature 30 days from May 1, 1945, unless prior to that time the New Corporation paid off the bonds which were not so extended (R. 176-177).

states unequivocally that "the Modified Bonds are to bear interest at the rate of 5½% per annum, *if and only* to the extent that the annual collections of net income received from the collateral after the Effective Date will suffice to pay such interest." (Emphasis added.) It is apparent that these bonds are "fully paid" as to interest when they receive the only interest to which this article entitles them, i.e., the earned interest.

That this is the only permissible meaning of this phrase is amply supported by the clear language of the Supplemental Trust Agreement. Even the Court of Appeals admitted that the Agreement "looks the other way" from the Court's conclusion, so that a contrary result was "hard to resist" (R. 620).

The Court of Appeals in this aspect pointed to §10 of Article II of the Agreement, providing that the guarantor's bonds should be paid after the Publicly-Held Bonds were "fully paid, purchased or retired by the [New] Corporation"; thus the rights of the Publicly-Held Bonds went no further than the obligation of the New Corporation. The Court of Appeals indeed ignored other strong language of the Agreement contrary to its conclusion: e.g., §8, Article II (R. 337), provides that on maturity "any deficiency or deficiencies of interest . . . will not become due and will not be paid by the Corporation *and any right to such deficiency or deficiencies will after the final maturity date be void and of no effect.*" (Emphasis added.) Further, sections 3-10 of Article VI, relate to the rights of the Trustee upon an event of default (R. 370-375), and Section 6 of such Article provides that the net proceeds of sale of the collateral by the Trustee pursuant to its rights upon an event of default shall be applied first to the pro rata payment of the principal of the Publicly-Held Bonds of

the Series, and, if the principal of all such bonds is paid in full, then to the pro rata payment of the principal of the subordinated bonds of the Series, and that if any surplus remains it shall be distributed as principal pro rata among the remaining Series (R. 373).

The Court chose its misconstruction of the Agreement upon the following reasoning: (a) The Plan could not legally deprive bondholders of their lien for interest; (b) the District Judge could not make a "materially adverse" change in the Plan so as to deprive them of this lien without affording creditors the right to withdraw their acceptances; (c) if he did so his order was illegal and is presently subject to collateral attack; (d) since the District Judge found that the Agreement made no "materially adverse" changes in the Plan, and the Plan is *now* found *by the Court of Appeals* to have preserved the right to a lien for full interest, the Agreement must also have done so, despite its clear language to the contrary.

This reasoning is patently specious both as to the law and the facts. As demonstrated above, the modification of the interest claim of Publicly-Held bonds was proper as a matter of law. That the finding by the District Judge that the Agreement, which clearly provides that the modified bonds shall be income bonds both as to their lien and as to the obligation of the New Corporation,[8] was consistent with the Plan and made no materially adverse change in the Plan, is supported by the fact that no creditor protested this order or took an appeal from it. This reflects the unanimous opinion at the time that the Plan had already modified the bonds so as to make them true income bonds in both

[8] This agreement was recommended by the Special Master after hearings and conferences participated in by numerous counsel and committees for bondholders (R. 576).

respects, and that the Agreement was in proper form to carry out the Plan.

Indeed, if any bondholders thought that these clear provisions of the Agreement did not comply with the Plan and believed that the District Judge's finding was erroneous, their remedy was by appeal, even if, as the Court of Appeals said at R.621, the right to withdraw consents were a *condition* upon the Court's power to approve at all any change from the Plan, contained in the Supplemental Trust Agreement. So too, their remedy was by appeal if they believed the Court was in error in directing the transfer to the New Corporation of the property dealt with by the Plan, free and clear of all claims except the claims of the holders of the bonds as modified. Failure to appeal from such order rendered *res judicata* the order that the Agreement complied with the Plan and that any changes were not "materially adverse". That order clearly provided that the bonds were income bonds both as to their lien and as to their claim against the New Corporation. The Court of Appeals, however, erroneously believed that if changes from the Plan contained in the Agreement were "materially adverse", the District Court had no power to make the changes, and its decision could now be attacked collaterally. This is squarely contrary to the holding of this Court in the *Sansberry* case, *supra*.

The Court of Appeals, completely disregarding the fact that the property dealt with by the Plan was transferred to the New Corporation nine years ago, that since then bondholders have irretrievably changed their position upon the assumption that when their bonds were declared to be income bonds their rights were so limited, now, in the guise of interpretation, has thus in reality amended the Plan of Reorganization and the Supplemental Trust Agreement and has modified the order directing the transfer of

the property dealt with by the Plan. If this decision stands the principle of *res judicata* is meaningless in the Second Circuit, and the rights and obligations under a plan of reorganization can never be finally established.

3. Further, the Court of Appeals approached the issue in the case upon the mistaken assumption that this was a controversy between the Publicly-Held Bonds, on the one side, and the Subordinated Bonds, on the other (R. 615) and concluded by saying "We sustain the position of the Publicly-Held Bonds."

The effect of the decision is to frustrate the pattern of reorganization bargained for here, among the 18 Series of bonds each with numerous public bondholders. As said above, this controversy is not merely between the guarantor and the Publicly-Held Bonds; the remaining surplus, now eaten by the back interest claim, was to be distributed pro rata among the other Series of bonds. The Plan of Reorganization, as was said, was a part of a united endeavor by all Series to recoup the principal from each Series (R 261-262). The instant decision is a spoliation of the rights of those other Series and not, as stated in the opinion below, the prevention of spoliation of the bondholders of this Series. The extent of the loss by the Publicly-Held Bonds in ten of the eighteen series will be collateral having a book value of $775,000 as shown by the table in Appendix B.

In holding that, under the decision of the District Court, some of the *res* would be released and turned over to the New Corporation, constituting a spoliation of the Publicly-Held Bonds, the Court of Appeals overlooked the fact that any surplus received by the New Corporation is, by express provision of the Supplemental Trust Agreement, made "subject to the lien of the Supplemental Trust Agreements

for the remaining series'' (R. 365) and is to be applied to the payment of bonds in such Series; and if any surplus remained after all the bonds are paid, the excess would also go to the bondholders, on their holding of the stock in the New Corporation.

WHEREFORE, it is respectfully requested that this petition for a writ of certiorari should be granted.

Respectfully submitted,

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Attorney for Petitioner, Prudence Realization Corporation.

APPENDIX A

NATIONAL BANKRUPTCY ACT

Section 77B

"(b) A plan of reorganization within the meaning of this section (1) shall include provisions modifying or altering the rights of creditors generally, or of any class of them, secured or unsecured, either through the issuance of new securities of any character or otherwise;"

• • • • • • •

"(5) shall provide in respect of each class of creditors of which less than two thirds in amount shall accept such plan (unless the claims of such class of creditors will not be affected by the plan, or the plan makes provision for the payment of their claims in cash in full), provide adequate protection for the realization by them of the value of their interests, claims, or liens, if the property affected by such interests, claims, or liens is dealt with by the plan either as provided in the plan (a) by the transfer or sale of such property subject to such interests, claims, or liens, or by the retention of such property by the debtor subject to such interests, claims, or liens, or (b) by a sale free of such interests, claims, or liens at not less than a fair upset price and the transfer of such interests, claims, or liens to the proceeds of such sale; or (c) by appraisal and payment either in cash of the value either of such interests, claims, or liens, or, at the objecting creditors' election, of the securities allotted to such interests, claims, or liens under the plan, if any shall be so allotted; or (d) by such method as will in the opinion of the judge, under and consistent with the circumstances of the particular case, equitably and fairly provide such protection;"

• • • • • • •

"(b)(9) shall provide adequate means for the execution of the plan, which may include the transfer of all or any

part of the property of the debtor to another corporation or to other corporations, or the consolidation of the properties of the debtor with those of another corporation, or the merger or consolidation of the debtor into or with another corporation or corporations, or the retention of the property by the debtor, the distribution of assets among creditors or any class thereof, the satisfaction or modification of liens, indentures, or other similar instruments, the curing or waiver of defaults, extension of maturity dates of outstanding securities, the change in interest rates and other terms of such securities, the amendment of the charter of the debtor, and the issuance of securities of either the debtor or any such corporation or corporations, for cash, or in exchange for existing securities, or in satisfaction of claims or rights, or for other appropriate purposes;"

* * * * * * *

"(f) After hearing such objections as may be made to the plan, the judge shall confirm the plan if satisfied that (1) it is fair and equitable and does not discriminate unfairly in favor of any class of creditors or stockholders, and is feasible; (2) it complies with the provisions of subdivision (b) of this section; (3) it has been accepted as required by the provisions of subdivision (e), clause (1) of this section; (4) the provisions of subdivision (e), clause (2), of this section have been complied with; (5) all amounts to be paid by the debtor or by any corporation or corporations acquiring the debtor's assets, and all amounts to be paid to committees or reorganization managers, whether or not by the debtor or any such corporation for services or expenses incident to the reorganization, have been fully disclosed and are reasonable, or are to be subject to the approval of the judge; (6) the offer of the plan and its acceptance are in good faith and have not been made or procured by any means or promises forbidden by this Act; and (7) the debtor, and every other corporation, issuing securities or acquiring property under the plan, is authorized by its charter or by applicable State or Federal laws, upon confirmation of the plan, to take all action necessary to carry

out the plan, and that, in case the debtor is a utility corporation subject to the jurisdiction of a regulatory commission or commissions or other regulatory authority or authorities, created by the laws of the State or States in which the properties of the debtor are operated, all authorizations, approvals, or consents of each such commission or authority required by the laws of such State or States, have been obtained.

"Before or after a plan is confirmed, changes and modifications may be proposed therein by any party in interest and may be made with the approval of the judge after hearing upon notice to creditors and stockholders, subject to the right of any creditor or stockholder who shall previously have accepted the plan to withdraw his acceptance, within a period to be fixed by the judge and after such notice as the judge may direct, if, in the opinion of the judge, the change or modification will be materially adverse to the interest of such creditor or stockholder, and if any creditor or stockholder having such right of withdrawal shall not withdraw within such period, he shall be deemed to have accepted the plan as changed or modified: Provided, however, That the plan as changed or modified shall comply with the provisions of subdivision (b) of this section and shall have been or shall thereafter be accepted as required by the provisions of subdivision (e), clause (1), of this section, including acceptances by reason of failure to withdraw as hereinbefore provided, and the provisions of this subdivision (f), and of subdivision (e), clause (2), of this section shall have been complied with in respect thereof. Upon confirmation of the plan by the judge, the debtor and other corporation or corporations organized or to be organized for the purpose of carrying out the plan, shall have full power and authority to put into effect and carry out the plan and the orders of the judge relative thereto.

"The provisions of subdivisions 1, 2, and 3 of schedule A of title VIII of the Revenue Act of 1926, as amended by sections 721, 722, and 723 of the Revenue Act of 1932 and

the provisions of sections 724 and 725 of the Revenue Act of 1932 shall not apply to the issuance, transfers, or exchanges of securities or making or delivery of conveyances to make effective any plan of reorganization confirmed under the provisions of this section."

* * * * * * *

"(h) Upon final confirmation of the plan, the debtor and other corporation or corporations organized or to be organized for the purpose of carrying out the plan, shall have full power and authority to, and shall put into effect and carry out the plan and the orders of the judge relative thereto, under and subject to the supervision and control of the judge, and the property dealt with by the plan, when transferred and conveyed by the trustee or trustees to the debtor or the other corporation or corporations provided for by the plan, or, if no trustee has been appointed when retained by the debtor pursuant to the plan or transferred by it to the other corporation or corporations provided for by the plan, shall be free and clear of all claims of the debtor, its stockholders and creditors, except such as may consistently with the provisions of the plan be reserved in the order confirming the plan or directing such transfer and conveyance or retention, and the court may direct the trustee or trustees, or if there be no trustee, the debtor and any mortgagee, the trustee of any obligation of the debtor, and all other proper and necessary parties, to make any such transfer or conveyance, and may direct the debtor to join in any such transfer or conveyance made by the trustee or trustees.

"Upon the termination of the proceedings a final decree shall be entered discharging the trustee or trustees, if any, making such provisions as may be equitable, by way of injunction or otherwise, and closing the case. Such final decree shall discharge the debtor from its debts and liabilities, and shall terminate and end all rights and interests of its stockholders, except as provided in the plan or as may be reserved as aforesaid.

"All securities issued pursuant to any plan of reorganization confirmed by the court in accordance with the provisions of this section, including, without limiting the generality of the foregoing, any securities issued pursuant to such plan for the purpose of raising money for working capital and other purposes of such plan and securities issued by the debtor or by the trustee or trustees pursuant to subdivision (c), clause (3), of this section, and all certificates of deposit representing securities of or claims against the debtor which it is proposed to deal with under any such plan, shall be exempt from all the provisions of the Securities Act of 1933, approved May 27, 1933, except the provisions of subdivision (2) of section 12, and section 17 thereof, and except the provisions of section 24 thereof as applied to any willful violation of said section 17."

* * * * * * *

"(j) A certified copy of the final decree or of an order confirming a plan of reorganization, or of any other decree or order entered in a proceeding under this section, shall be evidence of the jurisdiction of the court, the regularity of the proceedings and the fact that the decree or order was made. A certified copy of an order directing the transfer of the property dealt with by the plan as provided in subdivision (h) of this section shall be evidence of the transfer of title accordingly, and if recorded shall impart the same notice that a deed, if recorded, would impart."

* * * * * * *

APPENDIX B

Series	Publicly Held Bonds	Total Collateral(1)	Deficit(3)	Excess	Subordinated Bonds	Amounts Available for Subordinated Bonds and Liens if Interest Payable Only to Extent Earned	Surplus Available for Other Series After Payment of Subordinated Bonds if Interest Payable Only to Extent Earned	Record References
A	$ 278,349.00	$ 273,069.54	$ 5,279.46		$ 37,300.00	$ —0—	$ —0—	R. 450
AA	431,184.00	705,350.27		$ 274,166.27	138,100.00	138,100.00	136,066.27	R. 451
3	1,519,690.00	1,286,881.77	232,808.23		122,200.00	—0—	—0—	R. 453
4	216,104.00	162,880.52	53,223.48		21,100.00	—0—	—0—	R. 455
5	1,077,450.00	1,424,948.51		347,498.51	153,025.00(2)	153,025.00	194,473.51	R. 50–51
6	—0—	179,930.32		179,930.32	311,200.00	179,930.32	—0—	R. 458
7	455,800.00	229,202.98	226,597.02		118,500.00	—0—	—0—	R. 460
8	568,420.00	837,275.71		268,855.71	193,200.00	193,200.00	75,655.71	R. 461
9	1,452,850.00	1,914,447.92		461,597.92	193,824.98(2)	193,824.98	267,772.94	R. 583
10	476,465.00	109,201.53	367,263.47		19,000.00	—0—	—0—	R. 463
11	156,900.00	41,570.85	115,329.15		7,000.00	—0—	—0—	R. 464
12	272,896.00	526,404.71		253,508.71	390,500.00	253,508.71	—0—	R. 465
13	2,009,276.00	1,499,891.30	509,384.70		109,900.00	—0—	—0—	R. 467
14	948,800.00	768,587.33	180,212.67		70,200.00	—0—	—0—	R. 469
15	1,312,175.00	1,002,806.40	309,368.60		82,700.00	—0—	—0—	R. 471
16	1,092,157.00	515,154.62	577,002.38		2,200.00	—0—	—0—	R. 473
17	269,750.00	405,576.44		135,826.44	92,500.00	92,500.00	43,326.44	R. 475
18	651,240.00	729,998.12		78,758.12	21,800.00	21,800.00	56,958.12	R. 476
	$13,189,506.00	$12,613,178.84	$2,576,469.16	$2,000,142.00	$2,084,249.98(2)	$1,225,889.01	$774,252.99(4)	

(1) All figures for collateral are book value. Except for Fifth and Ninth Series, the figures for bonds outstanding and collateral are as of August 31, 1946.

(2) Figures for subordinated bonds in Fifth and Ninth Series include the subordinated liens of $85,825 in Fifth Series and $88,124.98 in Ninth Series, held by the former indenture trustee.

(3) In the ten Series having deficits the publicly held bonds total $8,465,716.

(4) Any of the surplus going to the Sixth and Twelfth Series would increase the amounts payable on the subordinated bonds of those Series. Part of any surplus going to Series A might be available to pay subordinated bonds in that Series.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1947

No. 572

PRUDENCE REALIZATION CORPORATION,
Petitioner,

v.

GEORGE E. EDDY, *et al.,*

REPLY BRIEF OF PRUDENCE REALIZATION CORPORATION, PETITIONER.

IRVING L. SCHANZER,
Counsel for Prudence Realization Corporation, Petitioner.

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I.

Respondents Eddy and the White group alone oppose the granting of the petition.* They contend that the Plan could legally provide for the payment of the subordinated bonds only after the publicly held bonds were fully paid in accordance with their original tenor. The petition shows (Pet. 12-13) that while senior creditors ordinarily must be paid in full before junior creditors take anything, surrender by the publicly held bonds here of their lien upon the collateral for interest not earned by it is permitted by well-recognized corollaries of the rule.

* Respondents Reconstruction Finance Corporation, Prudence Bonds Corporation (New Company), the Trustee of the Debtor, and Reese, *et al.*, bondholders, request that the petition be granted so that the decision of the Court below, which adversely affects not only the petitioner but the owners of publicly held bonds of the other Series as well, may be reviewed by this Court.

Both the respondents Eddy (Eddy Brief, pp. 19, 24) and the White group (White, *et al.* Brief, pp. 9-10) seek to avoid the impact of the cases relied on by Petitioner by questioning the sufficiency of the consideration given here. But the record does not support either claim. Since only $1,252,760.45 of the claims of the Prudence Trustees were general claims (R. 250), there is no basis for the charge by respondent Eddy that the $9,000,000 of disputed claims withdrawn by petitioner's predecessors on the settlement by which subordination of the guarantor's bonds was accepted, had already been disposed of by the earlier elimination of general claims. Nor is there any basis for the claim by respondent Eddy that all the stock of the New Corporation given to bondholders by the Plan was worthless.

II.

Both the respondent Eddy and the White group also contend that the instant case does not come within the doctrine of the cases relied upon by Petitioner, for the alleged reason that the compromise by which the guarantor's bonds were subordinated was not predicated upon modification of the interest obligation. In so contending they overlook the fact that what was compromised was the question whether the guarantor's bonds were entitled to parity or were to be subordinated, and not the question of how these bonds were to be treated if they were adjudicated to be subordinate. Section 11 of the Plan provided for the manner of the guarantor's participation whatever the judicial determination of the question on subordination might be (R. 178, 179).

In the event of subordination, the bonds of the guarantor were not to receive any distribution on account of prin-

cipal until the publicly held bonds had been fully paid, redeemed, purchased or retired. The Plan and the Supplemental Trust Agreement are specific in their provisions for the payment, purchase and retirement of the bonds. It is apparent that the provisions of the Plan and the Supplemental Trust Agreement with respect to payment of principal in the event of a determination of subordination limited the principal payments on the subordinated bonds until the payment, purchase, redemption or retirement of the publicly held bonds as modified by the Plan and in accordance with the provisions of the Plan. That such treatment was not necessarily the treatment to which the subordinated bonds might be entitled as a matter of law is evidenced by the fact that the limitations of principal payments are made specific but only the rights to payment of interest are limited to those "to which they may be legally entitled" (R. 179).

Thus, in exchange for the considerations referred to in the petition, the Plan provided, in the event of subordination, for less than full payment of interest at the original rates borne by the bonds. The Plan left for judicial determination the question whether the securities held by the guarantor were to be subordinated or accorded parity of treatment with the publicly held bonds, but provided for the method of participation by the subordinated bonds in the event that they were held to be subordinate. (*Cf. Prudence Realization Corp.* v. *Ferris,* 323 U. S. 650, 654; Ibid., R. 120-122.) Accordingly, the compromise in this case was predicated upon the provisions of the Plan, which provided for only income interest on the bonds.

The opposing respondents, although ignoring the income interest provisions, now seek to take advantage of all the other provisions of the Plan such as those for the retirement through sinking fund operations of other bonds

at substantially below par, for if such bonds in substantial amounts had not in fact been retired under the provisions of the Plan, the funds presently available would be insufficient to pay the full amount of principal and interest to which the present respondents make claim.

III.

The briefs of both Eddy and the White group emphasize the necessity for a review by this Court of the disregard by the Court of Appeals of the well settled principles of *res judicata* referred to in the petition. The respondent Eddy claims that the order approving the Supplemental Trust Agreement cannot be accorded any greater degree of finality than if the Plan had provided that it should be approved by counsel (Eddy Brief, pp. 21-22), and that there would be a final adjudication within the rule of *res judicata* only after an adversary proceeding in which the rights of the parties under the Agreement were presented to the Court for determination. The contention of the respondent Eddy is in direct conflict with the cases referred to in the petition.

The White group contends that if the Supplemental Trust Agreement contained any changes from the Plan its approval by the Court was wholly void and subject to collateral attack. The violence which this contention does to the precedents of this Court as set forth on pages 13 and 14 of the petition, is brushed aside by respondent White by quotation from *Kalb* v. *Feuerstein,* 308 U. S. 433, 438, 439. In that case, however, this Court re-stated the established principle of *res judicata* and held that Congress could "by specific bankruptcy legislation create an exception to that principle" (*Kalb* v. *Feuerstein, supra,* at

pp. 438, 439). Neither the respondent nor a reading of the statute discloses the creation of such an exception for the present case.

Conclusion.

Wherefore, your petitioner prays that its petition for writ of certiorari be granted.

Respectfully submitted,

IRVING L. SCHANZER,
Counsel for Prudence Realization Corporation, Petitioner.

March 1948.

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IN THE

Supreme Court of the United States

October Term 1947
No. 572

PRUDENCE REALIZATION CORPORATION

Petitioner,

against

GEORGE E. EDDY, *et al.*

BRIEF OF RESPONDENT GEORGE E. EDDY IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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SUPREME PRINTING CO., INC., 41 MURRAY STREET, N. Y., BARCLAY 7-0349
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Opinion Below

The opinion of the Circuit Court of Appeals for the Second Circuit is printed in the Record at pages 614-624.

The opinions of the District Court, unreported are printed at R. 22-47, 479; and the unreported opinion of the Special Master is printed at R. 28-72.

Jurisdiction

The petitioner invokes the jurisdiction of this Court under Section 240 (a) of the Judicial Code, as amended, and under Section 24 (c) of the Bankruptcy Act, as amended.

Question Presented

Under the plan of reorganization of the collateral underlying outstanding bonds of the Debtor (after an adjudication that the Debtor was insolvent and it and its general creditors were adjudged to have no interest in such collateral), did the Circuit Court below correctly interpret the plan, in holding that the public holders of the bonds in the several eighteen issues of Prudence Bonds, are entitled to receive payment in full of the principal of their bonds, together with interest thereon at the rate of 5½% per annum, as guaranteed by the Prudence Company, Inc. before said guarantor, or its successor, Prudence Realization Corporation, petitioner herein, as a holder of some of the bonds can participate in the distribution of the proceeds of the respective trust funds?

Statement

The District Court by four orders directed payment to be made of the subordinate bonds of the guarantor's successor, the petitioner herein, although the deficiency in the payment of the accrued interest on the publicly held bonds at the guaranteed rate of 5½% in the Fifth Series amounts as of August 1, 1945, to $411,783.18 (54); such deficiency in interest payments to the public bondholders in the Ninth Series, as of August 1, 1945 amounts to $604,606.17; the like deficiency in the Sixth Series as of July 26, 1946 amounts to $251,405.28 (499); and similar deficiencies in interest payments to the public bondholders exist as to all other series of said bond issues.

The Circuit Court construed and interpreted the plan of reorganization herein and reversed the District Court.

Such reversal was predicated on the special circumstances and facts involved in the particular relationship to the trust funds of the public bondholders and the guarantor of the bonds.

No controversy of public interest or importance with respect to legal principles is involved. The decision of the Circuit Court does not conflict with any decisions of other Circuit Courts, and is in conformity with equitable principles as heretofore established by this Court.

The Facts

Prudence Bonds Corporation, the Debtor was a corporation organized under the Business Corporation Law of New York, with a capital stock of $50,000, all of which was owned by New York Investors, Inc. (241-242). The Prudence Company, Inc. was organized as an investment company under the Banking Law of New York State. All of its common stock outstanding and also 50% of its outstanding preferred stock were owned and held by New York Investors, Inc. Both the Debtor and The Prudence Company, Inc. were subsidiaries of and completely controlled by New York Investors, Inc. (242), and were organized by it to engage in the guaranteed mortgage in vestment business (242-243).

To that end, various bonds and mortgages, cash and other securities owned by The Prudence Company, Inc., were transferred by it to the Debtor, and by the latter, in turn, transferred under trust agreements to various trust companies as trustees to secure the payment of the debtor's bonds, which were delivered by the Debtor to The Prudence Company, Inc. (243). There were eighteen series of such bonds aggregating $56,000,000 (109). Thereupon, The

Prudence Company, Inc. sold the bonds to the general public and guaranteed their payment, both as to principal and interest (109), which was at the rate of 5½% per annum (110). In this way there was sold and transferred to the public all but $1,910,300 of such bonds, which remained in the possession of or were held by the guarantor (31; 111).

This was the situation of the Debtor when on June 29th, 1934 it filed its petition for reorganization under Sec. 77B of the Bankruptcy Act, and trustees were duly appointed, qualified and acted as such. Clifford S. Kelsey is the sole surviving Trustee of the Debtor (29).

The Debtor's first proposed plan related solely to the Fifteenth Series of its bonds, and the object sought to be attained thereby was to scale or cut down its obligations on its bonds by a modification of their terms; extending the maturity of the bonds to May 1, 1945; reducing them to income bonds up to 4½% and cumulative income at 3½% payable on maturity, and reducing the obligations of the guarantor, The Prudence Company, Inc. to a guaranty of the bonds only as modified (194; 206-7). This proposed plan was amended so as to incorporate a provision for the separate reorganization of each of the Eighteen Series of Bonds as a step for the complete reorganization of the Debtor under a General Plan (208).

The respondent Eddy, duly filed objections to said plan based, among others, on the contentions that the plan was unfair and inequitable because the Debtor was insolvent and it "was a device to prefer the stockholders of the Debtor and the New York Investors, Inc., and The Prudence Company, Inc., to the creditors of the Debtor and secure the subordinate rights of such stockholders at the expense of the prior rights of the creditors" and "that the acceptance and

confirmation of such plan would violate the 5th Amendment to the Constitution of the United States" (212).

The said plan and objections were referred to James G. Moore, Esq., as Special Master, for hearing and report. By his report dated March 29th, 1935 (212); he rejected the authorities relied on by respondent, namely, the cases of *Northern Pacific R. R. Co.* v. *Boyd*, 228 U. S. 482; *Florscheim* v. *Mechanics etc. Bank*, 206 N. Y. 745; and *In re Hopkins Laks Drive Corporation*, U. S. D. C. Md. Dec. 6, 1934 (no official citation) and recommended that the objections be overruled (215-216) and the plans be approved as being feasible and equitable (211). The necessary consents of two-thirds of the bondholders had not been obtained, but nevertheless the District Court confirmed the said report in October, 1935, overruled said respondent's objections thereto, approved the plan as filed in good faith and adjudged that it was fair and feasible[1] From this order, no appeal was taken by respondent Eddy.[2]

---

[1] The learned judge below in his opinion, dated October 29, 1935 stated:

> "It seems to me that the plan proposed is a fair and feasible one * * *
>
> Of course, no confirmation of the plan can take place until it has been accepted by the required number of consents, but I see nothing in the objections that this Court must refrain from expressing its opinion of the proposed plan until such consents have been filed and the matter is before the Court for final confirmation. * * *"

[2] Counsel advised Mr. Eddy that the order was only tentative and could not be made final until the plan was consented to by the requisite number of bondholders and as the proposed plan had not been accepted and confirmed he in no way suffered injury and the decree was therefore not appealable. It was not until September 1938 that the scope of the Appellate jurisdiction of the Circuit Court was clearly broadened by the Chandler Act to cover appeals from all interlocutory orders in reorganization proceedings.

Thereafter similar separate plans of reorganization of the other seventeen series were proposed by the Debtor, the only substantial change being in the modification of the bonds to income bonds up to interest at the rate of 5½% and the omission of any provision for cumulative interest at a fixed rate (164; 219).

The Debtor, failing to secure the desired consents to such plans, and meeting with strenuous opposition to the provision relating to the guaranty of The Prudence Company, Inc., again amended its proposed plans by eliminating the provision reducing The Prudence Company, Inc., guaranty to a guaranty only of the payment of the bonds as modified, and substituting therefor a provision preserving the rights of the bondholders on the said guarantees to the extent permitted by law (178-179; 221).

Subsequently and about August, 1936, the clause relating to said guaranty was further amended by an additional paragraph being added thereto and providing that—if, as a matter of law, the bonds owned by The Prudence Company, Inc. are subordinate to the Publicly Held Bonds, such bonds so held by the guarantor shall not be entitled to receive any distribution of the proceeds of the Trust Funds "Until all of the Publicly Held Bonds have been fully paid, redeemed, purchased or retired" (179).

All these plans proposed by the Debtor contained similar provisions for the modification of its bonds and converting them to bonds bearing interest at 5½% if earned (164); all contained a clause providing for their integration into a general plan for the complete reorganization of the Debtor (222; 208).

About February 11, 1936, the Debtor proposed a general plan of reorganization which was referred to James G. Moore, Esq., for hearing and report (225, 227).

In the interim, from the time of the approval by the Special Master and the District Court of the plan for the Fifteenth Series in October, 1935, and pending the consideration of the general plan and the other Seventeen Series separate plans, the Circuit Court in March, 1936, rendered its decision in *re N. Y. Railways Corporation,* 82 F. 2d. 739, re-affirming the doctrine of *Northern Pacific R. R. Co.* v. *Boyd,* 228 U. S. 482. Certiorari was denied June 1st, 1936, 298 U. S. 687; and this Court rendered its decision in *Re 620 Church Street Building Corp., et al.,* 299 U. S. 24 and *Tennessee Publishing Co.* v. *American National Bank,* 299 U. S. 18, on November 9th, 1936.

Thereupon and on March 11, 1937, the Special Master rendered an intermediate report on the Debtor's general plan wherein he found "that the Debtor is insolvent; that the fair market value of all of the assets pledged to secure all of the series of First Mortgage Collateral Bonds of the Debtor is insufficient, in each series, to pay the Debtor's obligations for principal and interest upon said First Mortgage Collateral Bonds; that the Debtor has no equity in the pledged collateral; that the general creditors have no equity in the pledged collateral; * * *" (259) and concluded

> "It necessarily follows, as conclusions of law, that the Debtor's Plan is unfair and inequitable; that it discriminates unfairly in favor of general creditors and stockholders as against the bondholders and that it cannot be approved in its present form" (260).

Up to the time this intermediate report of the Special Master was made, the bondholders consisting of the general public and The Prudence Company, Inc., were classified as

one group of creditors of the Debtor (212), and the Special Master apparently assumed that The Prudence Company, Inc., as guarantor of the bonds, and the public bondholders had a co-ordinate and equal interest in the collateral trust funds (218).

The said intermediate report stated that the proceeding for the reorganization of the Eighteen Series of the Debtor's bonds were being conducted on the theory that for reasons of efficiency and economy it was advantageous to the bondholders that they unite in a reorganization by which their several interests would be under the management of one corporation whereby they "should not only preserve for themselves the full value of their own collateral, but by union, they should enable the less fortunate to be benefitted from any excess of collateral of the better issues (261-262).

To attain these objects the Special Master proposed the amended general plan for the reorganization of the Debtor, entirely eliminating the Debtor, its stockholders and general creditors from the picture; and providing that a new corporation be formed to be owned and controlled by the bond holders (262-263).

On April 27, 1937, the District Court approved and confirmed the Special Master's report and adjudged that the Debtor was insolvent and that the fair value of the collateral securing each of the Eighteen Series of Bonds was less than the principal amount of the outstanding bonds and accrued interest thereon, and that the Debtor, its stockholders and general creditors had no equity in such collateral (275).

The said report of the Special Master dated March 11, 1937, analyzed the value of the collateral underlying the

Eighteen Series of Bonds and disclosed that in each series the collateral was less than the outstanding publicly held bonds. In the Sixteenth Series the deficit of the collateral to meet the outstanding bonds was $904,394.74 (256, 257), the amount of the bonds held by The Prudence Company, Inc., was but $2,200 (32) making the deficit to meet the publicly held bonds and interest over $902,000. In the Tenth Series he found the deficit to be $360,000 (257). The Prudence Company, Inc., held $19,000 (32) of Tenth Series Bonds, leaving the Trust Fund deficit of over $340,000 to meet the publicly held bonds.

But no recommendation was then made, nor was any order then entered, to eliminate The Prudence Company, Inc., from participation in the proceeds of the collateral underlying the Eighteen issues of the Debtor's bonds.

However, by an order made July 21, 1937, based in part on a supplemental report of the Special Master dated April 27, 1937, it was adjudged and decreed that the bonds that had been held by the guarantor (which was itself in reorganization), and then held by its Trustees, were subordinate to the bonds of the general public; that they were not entitled to share in the collateral securing the Eighteen Series of bonds and are not enforceable obligations either as to principal or interest against their respective trust funds, or the proceeds thereof * * * until all other Prudence Bonds in the hands of the general public have been provided for in full, both as to principal and interest heretofore accrued or hereafter accruing * * * but if and when and only after all other Prudence-Bonds in the hands of the general public in a particular series have been paid or provided for in full, both as to principal and interest, as

aforesaid, then, and in that event only, said Prudence-Bonds held by the said Trustees of The Prudence Company, Inc., in that particular series are entitled to share in the said collateral and proceeds thereof as aforesaid; * * * (112-113).

From the said decree determining and fixing the relationship to the trust funds of the public bondholders and the guarantor as a holder of some of the bonds, the guarantor's trustees in reorganization appealed to the Circuit Court. The Court of Appeals of New York on July 13, 1937, had handed down its decision in the *Matter of Title & Mortgage Guarantee Co.*, 275 N. Y. 347, indicating that a guarantor as part owner of the obligations guaranteed by it was not entitled to share in funds securing such obligations on a parity with the public owners of such obligations so guaranteed by it.

Thereupon, a compromise and settlement was effected between the Trustees of The Prudence Company, Inc., and the Trustees of the Debtor herein for the withdrawal of said appeal upon the payment to the former of $150,000 out of the trust funds as a reorganization expense (R. 147 F. 2d 465; 483, 487).* This settlement was approved by an order of the District Court entered January 7, 1938 (113).

Upon the determination by the Court that the Debtor was insolvent and the entry of the order eliminating the Debtor, its stockholders and unsecured creditors from any share or interest in the Eighteen Series Trust Funds, the plans theretofore proposed by the Debtor and which had for their object the "scaling down" of its obligations and

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* Refers to Record in *President and Directors of Manhattan Company* v. *Kelby*, cert. den'd 324 U. S. 866.

the creation thereby for the Debtor of a previously non-existent equity in the various trust funds at the expense of the bondholders were necessarily unfair, inequitable and not feasible and ran counter to the Court's decision and order. It became necessary therefore to convert the proposed Debtor's plans to plans for the reorganization solely of the bondholders' rights in the collateral securing the respective series of bonds.

At that time, the bondholders relied on the order of July 27, 1937, and rightly believed that as all of the Eighteen Trust Funds were insolvent the only parties entitled to share in any distribution of the proceeds of the trust funds were the public bondholders to the extent that such funds realized sufficient to pay the public bondholders the principal of their bonds, together with the interest thereon at the rate of 5½% per annum, and only after the payment of the publicly held bonds in full with interest accrued and to accrue at such rate of 5½% could there be an excess or surplus available for the discharge of the subordinate bonds of The Prudence Company, Inc., guarantor, or its successors in interest.

With the avowed purpose of preserving these rights of the public bondholders, and with the intent of preserving for them the "full value of their own collateral" (262) the proposed plans of the Debtor were modified under the supervision of the representative of the Court, i.e. the Special Master, and it was assumed that by changing the definitions so as to eliminate the Debtor from the picture and by adding provisions integrating each plan with the General Plan proposed by the Special Master in his report of March 11, 1937 the object sought was fully attained (272;

181). It was not suggested to the public bondholders that acceptance of the plans so amended would vitiate the order of July 21, 1937, or would diminish their priority rights over the subordinate bonds of The Prudence Company, Inc. and its successors; or that such subordinate bonds would be able to participate in the Trust Funds before the priority bonds were paid in full with interest at 5½%; or that the effect of the plan would be to transfer to the subordinate bondholders the equity in any potential difference between the earned income and fixed interest at the rate of 5½%; nor was any consideration paid by the subordinate bondholder to support and validate any such claimed transfer.

About January 18th, 1938 the amended general plan and the separate plans for each series except the Fifteenth Series were approved and confirmed (114). The new corporation owned by the bondholders as the sole stockholders was organized pursuant to the plan (115); March 1st, 1938 was fixed as the effective date of the Plan of Reorganization, and Supplemental Trust Agreements were entered into between the New Corporation and City Bank Farmers Trust Company as Trustee of all eighteen trust funds (117). No new capital was invested in the New Company but it received funds to pay reorganization expenses and for operating capital by contributions from the eighteen trust funds (Ex. A, 574).

The Supplemental Trust Agreements recited that the bonds shall bear interest * * * at the rate of 5½% per annum "if and only to the extent that the annual collections of net income * * * received from the collateral shall suffice to pay such interest." The maturity date of the bonds was extended to May 1, 1945, and it was provided that

"Any * * * deficiency or deficiencies of interest remaining on May 1, 1945, or if the maturity of the Bonds be extended remaining on May 1, 1950, will not become due and will not be paid by the Corporation and any right to such deficiency or deficiencies will after the final maturity date be void and of no effect" (121). The several plans contained no provisions voiding the bondholders rights to such deficiencies. On the contrary, the plans provided that the old trust indenture should be modified to conform to the plan and that the Modified Trust Indenture shall include such additional or substitute provisions, not inconsistent with the plan as may be necessary to carry out the Plan (176-177), and the order approving the form of Supplemental Trust Agreement proceeds on the assumption that the agreement was in compliance with the respective separate plans of reorganization theretofore confirmed and did not materially change or modify any provisions of the plans (664). By each Supplemental Trust Agreement it was also specifically provided that the purpose of the Supplemental Trust Agreement was to set forth the amendments and modifications required in the original trust agreements by the plan of reorganization (318) and also that the agreement of guaranty of The Prudence Company, Inc., * * * the texts of the Bonds * * * and the guaranty of the Prudence Company, Inc. * * * shall remain as set forth in the Original Trust Agreement (321). The several Supplemental Trust Agreements were not submitted to the bondholders for their approval and consents thereto, but were approved by the Court as not materially or adversely affecting the rights of those who theretofore accepted the plans of reorganization (R. 147 F. 2d 465; 1512-1513; 324 U. S. 866).

By orders dated April 27, 1938 and June 6th, 1938 the indenture trustees were directed to transfer the respective trust funds to City Bank Farmers Trust Company; and were authorized to file their respective accounts of their acts and proceedings as trustees and apply for a judicial settlement thereof (116-117).

As a result of such accountings the accountant trustee in the Fifth Series was surcharged with and paid into the Trust Fund on May 16th, 1945 the sum of $1,572,991.03 (437); and on the same date paid a surcharge in the Ninth Series in the sum of $221,533.04 (439). In all other series, except Series A, 10th and 15th, which are still pending, the indenture trustees paid various sums in settlement of the objections to their accounts, with the approval of the District Court.

The payments of the surcharges in the Fifth and Ninth Series, brought about a new situation which was not within the contemplation of the public bondholders at the time the plans were accepted and confirmed, and at the time the supplement trust agreements were entered into between the New Corporation and the successor trustee.

It transpires that after the distribution to the public bondholders of the earned income in the Fifth Series—said income being insufficient to pay interest at the rate of 5½%—there will remain in principal account a sum adequate to pay the principal amount of the publicly held bonds and leave a substantial surplus. The same situation is presented in the Sixth and Ninth Series, and may arise in some of the other series.

By a report of the Special Master, dated March 11th, 1938, the amount of outstanding bonds in the respective

series was fixed; also, the date to which interest thereon had been paid at the rate of 5½% as of the effective date of the plans; also, the sums to be paid out of the corpus of the respective trust funds to the New Corporation for operating and reorganization expenses, and to be advanced or loaned from income account where cash was not available in principal amount to pay same (Ex. A; 574).

In the present controversy, the Special Master in respect to the Fifth and Ninth Series recommended that after payment of the principal of the outstanding publicly held bonds, the trust *res* should be applied to the payment of the principal of the guarantor's subordinate bonds; [in the Fifth Series $67,200 (55) and in the Ninth Series $105,700 (547, 583)] to a repayment by way of recoupment to the surcharged accounting trustee [in the Fifth Series $85,825 (57) and in the Ninth Series $88,124.98 (547, 583)], and that any excess then remaining should be distributed to other series of Prudence Bonds.

The District Court adopted said recommendation, although there was an unpaid deficiency of interest due the public bonds in the Fifth Series of $411,783.18 (54) and in the Ninth Series of $604,606.17 (541, 586). In the Sixth Series the deficiency of interest due the public bondholders is $251,405.28 (499). By the order relating to all series, the District Court instructed the Trustee to make like distributions, notwithstanding that in each series there is a similar unpaid deficiency of interest due the public bondholders, and in each series the trust fund is inadequate to discharge the principal and interest at the guaranteed rate of 5½%. By disregarding the unpaid interest due to public bond-

holders, the decrees award to the guarantor's subordinate bonds the right to share in the distribution of the respective trust *res*.

The Circuit Court of Appeals unanimously reversed the District Court and held that the public bondholders are entitled to be paid the said deficiencies in interest before the subordinate bondholders can participate or share in such distribution (614-618).

The Order Subordinating Bonds Held by Prudence Realization Corporation, and the Settlement Agreement

The Prudence Company, Inc., predecessor of the petitioner, filed its claims herein as holder of $1,910,300 face amount of the Debtor's bonds, with interest thereon (32). It also filed claims as a general creditor in the aggregate amount of approximately $9,000,000 (250).

By the order of April 27th, 1937, the Debtor was adjudged insolvent and that the Debtor, its stockholders and general creditors have no equity in the pledged collateral in any of the Eighteen Series of the Debtor's bonds (275, 110). From this order no appeal was taken.

By a decree made July 21st, 1937, it was adjudged that the bonds in the aggregate sum of $1,910,300 now held by Prudence Realization Corporation, the petitioner herein, were subordinate to the publicly held bonds, and were not entitled to any share of the proceeds of the respective trust funds until the publicly held bonds were "paid or provided for in full, both as to principal and interest heretofore accrued or hereafter accruing * * *" (112-113).

From said decree the petitioner herein appealed to the Circuit Court below, and before decision, a compromise and settlement was made and the appeal withdrawn, with the approval of the District Court (113-114).

The petition and settlement agreement respecting said appeal are contained in the Record on Appeal in the proceeding entitled, *President, etc. of the Manhattan Company* v. *Kelby,* pages 467-496; before this Court on a petition for a writ of certiorari, which petition was denied in 324 U. S. 865 ~~865~~ 866.

The agreement of subordination of the guarantor's bonds subordinated such bonds to the rights of the bondholders as defined in paragraph 11 of the several plans of reorganization and the order of July 21, 1937 (R. 324 U. S. 465, 5th Series, p. 488, fol. 1446) and provided:

> "Nothing herein contained or the execution or consummation of this agreement is in any way, to affect, vary, impair or increase the rights of the bondholders of the Eighteen Series of Prudence-Bonds with respect to the guarantee thereof made by The Prudence Company, Inc." (R. 324 U. S. 465, 5th Series p. 488, fol. 1463.)

POINT I

The Petition herein does not present any special question of public importance; there is no conflict with decisions of other circuits, the State Courts, nor this Court, so as to merit review.

(a)

The decision below determined the priority rights of secured creditors under the terms of the plans of reorganization. It construed what it considered equivocal language, in the light of the surrounding factual circumstances, and in so doing, it follows the principles of equity as enunciated by this Court in,

Vanston Committee v. *Green*, 329 U. S. 156;
Consolidated Rock Co. v. *Du Bois*, 312 U. S. 510;
Group of Investors v. *Milwaukee Railway Co.*, 318 U. S. 523;
Case v. *Los Angeles Lumber Co.*, 308 U. S. 106;
Northern Pacific Railroad Co. v. *Boyd*, 228 U. S. 482;

and by the New York Court of Appeals in,

Florscheim v. *Mechanics & Traders Bank*, 206 N. Y. 745, reversing 137 App. Div. 149 on dissenting opinion of Clark, J.

The petitioner concedes that ordinarily senior creditors must be paid in full before junior creditors may take anything; but urges that the rule does not apply in the instant case—because it claims the right of seniority of the

public bondholders was disputed—and such senior rights were partially surrendered under a compromise based upon valuable consideration. But this contention is belied by the undisputed facts.

In the compromise of petitioner's claim, there was no surrender by the public bondholders of their full legal priorities—on the contrary, they were fully preserved. By the withdrawal of its appeal, the petitioner herein accepted the order of July 21st, 1937, as the final adjudication of its status as a subordinate bondholder, and that the public bondholders were entitled to receive payment of their bonds in full together with interest accrued and thereafter accruing, before it could share in the proceeds of the trust funds.

Again, to support the alleged surrender by the public bondholders of their priority rights, petitioner suggests that it waived approximately $9,000,000 worth of claims—but in truth and fact the claims were worthless. They were general claims against the Debtor corporation. The Corporation had been adjudged insolvent and its general creditors and stockholders were eliminated by the prior order of April 27th, 1937, from which no appeal was taken. The petitioner paid no consideration for any surrender by the public bondholders of their priority rights, but on the contrary the bondholders paid $150,000 for a claim that had no greater dignity than a "sheer nuisance value." *Case* v. *Los Angeles Lumber Co., supra.*

The compromise agreement did not subordinate the petitioner's bonds to the publicly held bonds "as modified by the plans" but to the rights of the bondholders as subordination is defined in paragraph 11 (R. 178) of the sev-

eral plans (R. 324 U. S. 866; p. 482) and as such rights were adjudicated by the order of July 21st, 1937. Indeed, the specific provision of the compromise agreement was that thereby the rights of the bondholders should *not be varied or impaired* with respect to the guarantee of The Prudence Co., Inc. (R. 324 U. S. 866, p. 488, fol. 1463).

The sole question then that the Circuit Court adjudicated was what those rights of the public bondholders were --and its decision is in full accord with the decisions of this Court and the Courts of New York State.

Ticonic National Bank v. *Sprague,* 303 U. S. 406;
Ferris v. *Prudence Realization Corporation,* 292 N. Y. 210, aff'd 323 U. S. 650;
In the Matter of Title & Mortgage Guarantee Co., 275 N. Y. 347;
Lawyers Title and Guaranty Company, In Re Forshay, 279 N. Y. 571 aff'g 254 App. Div. 653, aff'g 169 Misc. 266;
Pink v. *Thomas,* 282 N. Y. 10;
In Re Home Title Insurance Company (*Mortgage No.* 19103), 255 App. Div. 635.

(b)

The petitioner, failing to point out any provision of the plan of reorganization or the compromise agreement to support its erroneous claims that such documents effected a modification of the rights of the public bondholders so as to reduce the obligation of the guarantor to a guarantee of payment only of the earned income, advanced the specious contention that, in any event, such reduction of the rights of the bondholders and the liability of the guarantor

were accomplished by reason of the provisions of the supplemental trust agreement; that the District Judge had rendered a decision that the supplemental trust agreement did not materially affect the rights of the bondholders—and as no appeal was taken, such decision is final, even if erroneous, and therefore the decision of the Circuit Court below is in disregard of settled principles of *res judicata* and in conflict with decisions of this Court and other Circuit Courts of Appeals; citing various cases which are inapposite and have no relation to the facts in this case.

The order approving the supplemental agreement was made after the order of confirmation of the plan of reorganization. The latter order stemmed from the power conferred and the duty imposed on the District Court by the provisions of the Bankruptcy Act, Sec. 77B. f. Such an order was an adjudication that determined conflicting rights, having all the incidents of a judgment or decree, after a due trial. Of course, such order, in the absence of an appeal, is final and *res adjudicata* as to all matters comprised within the litigation. The precedents relied on by petitioner pertain to such a final decree, and are inapposite to an incidental order, subsequent to the litigation, and which has its origin or basis, not in any provision of the statute, but in the terms of the plan.

It was by virtue of a provision of the plan that the District Court made the order approving the supplemental trust agreement. The plan provided that "The present Trust Indenture shall be modified *so as to conform with the Plan,*" and shall contain such additional or substitute provisions *"not inconsistent with the Plan* as may be necessary or advisable *to carry out the Plan"* (175) and "shall be subject to the approval of the Court" (176).

The supplemental trust agreement was not intended to be the medium of effecting any material alteration or modification of the rights of of the public bondholders, or to change or in any way amend the Plan. It was not proposed and offered for the approval of the Court as "amending" the plan, and the order approving the form of the agreement was not the result of an adjudication by the Court of contested rights of adversary litigants. The Court approved the "form of Supplemental Trust Agreement" recommended by the Special Master (660, 661) and was so thoroughly unapprised that such form of Supplemental Trust Agreement proposed any material modification of the plan that in the provision of the order directing the execution of the Supplemental Trust Agreements as to each of the Eighteen Series of bonds, he directed that each Supplemental Trust Agreement "may * * * be submitted to this Court without notice for ex-parte approval" (665).

The approval of the form of Supplemental Trust Agreement by the Court cannot be accorded any greater degree of finality than if the plan had provided that the supplemental trust agreement should be approved by counsel. If counsel approved the agreement, there would still be open for adjudication by the Court the question whether the parties entering into such agreement exceeded the powers and authority conferred upon them by the Plan, and a final adjudication within the rule of *res adjudicata* would be applicable only after by adversary proceedings the issue of the rights of the parties under the agreement were presented to the Court for determination. The rule has no application to a summary order, where the issue was not directly presented to and passed on by the Court.

Hill v. *Wampler*, 298 U. S. 460, 466;
Matter of Hidden, 243 N. Y. 499;
American Equitable Corporation v. *Parkhill*, 252 App. Div. 260.

In the instant case the Special Master reported on those provisions of the Supplemental Trust Agreement which in any way deviated from or changed the plan, and recommended that such modifications were not material or adverse to the interests of the bondholders (675; 677). Those particular modifications of the plan directed to its attenion the Court passed on and approved.

As to the rest of the agreement, which "descends to particulars not found in the plan" the Special Master did not direct the attention of the Court thereto; he did not direct the attention of the Court to Sections 8 and 10 of Article II of the Supplementary Trust Agreement or suggest that thereby the plan was being modified or amended; but reported that such particulars "are in accordance with the spirit and purpose of the plans and are in no sense modifications of or amendments to said plans" (676).

Obviously, therefore, the question of whether Sections 8 (336) and 10 (340) of Article II of the Supplemental Trust Agreements conflicted with Section 11 of the plans (178) and the order of July 21, 1937 (112) and the terms of the compromise agreement (R. 324 U. S. 866, pp. 482-488) was not presented to the Court for determination and was not passed on by it; and the principle of *res judicata* is inapplicable to the facts in this case.

It is clear from a reading of the plan of reorganization, that the dominant purpose of the plan was to preserve all

the legal rights of the public bondholders; to create a servicing agency to liquidate the collateral underlying the respective eighteen bond issues in the interests of the public bondholders, and that their priority rights in such collateral should remain unimpaired, "irrespective of the provisions of this Plan" (178-179).

The contention that ownership of the stock of the New Corporation and the right to share in the income of the New Corporation and in any excess collateral of other series constituted compensation to the public bondholders equivalent to a surrender of their priority rights in the respective eighteen trust *res* is unrealistic and ignores the fact that we are dealing with an insolvent estate; that the liquidating agent, i.e., the New Corporation, had no assets except as taken from the trust funds constituting the collateral underlying the publicly held bonds; and had no source of income except as derived from the servicing and liquidation of such collateral; and as a liquidating agent it could in no way be responsible except to perform its duty to apply the income received and the proceeds of the collateral to the *pro rata* payment of the publicly held bonds. Of course, the New Corporation could not be obligated to pay more income than was received, and its *pro forma* agreement to pay the principal of the bonds at the extended due date was an unenforceable promise except only insofar as such collateral realized sufficient to pay the same. A realistic view of the relationship of the public bondholders and the New Corporation is that they were principal and agent and not creditor and debtor. If it be assumed that the New Corporation was a debtor, and not merely a liquidating agency, then the New Corporation was totally in-

solvent from its birth, as it possessed no assets save only the right to service the collateral. (*Central Hanover Bank and Trust Company* v. *President & Directors of the Manhattan Company,* 105 F. 2d 130.)

CONCLUSION

The petition for a Writ of Certiorari to the Circuit Court of Appeals for the Second Circuit should be denied.

SAMUEL SILBIGER,
Counsel for Respondent, George E. Eddy.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1947

No. 572

PRUDENCE REALIZATION CORPORATION,
Petitioner,

v.

GEORGE E. EDDY, et al.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENTS JAMES L. WHITE, SARA WHITE, EVELYN B. WHITE, SYBIL A. WHITE AND CORA BENTON

FRANK L. WEIL,
Attorney for Respondents, James L. White, etc.

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Opinions Below

The opinion of the Circuit Court of Appeals for the Second Circuit is as yet unreported but is printed in the Record at pages 614-623.

The opinions of the District Court are unreported but are printed in the Record at pages 22-47 and 479.

Jurisdiction

The decree of the Circuit Court of Appeals was entered on December 8, 1947 (R. 623). Petitions for rehearing filed in that Court were denied on January 5, 1948 (R. 650). The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended, 28 U. S. C., Section 347(a), and Section 24(c) of the Bankruptcy Act, as amended, 11 U. S. C., Section 47(c).

Question Presented

Are the Publicly-Held Bonds entitled to interest in full, that is, 5½%, up to the time of their payment, in accordance with their original tenor?

Statute Involved

The pertinent provisions of the Bankruptcy Act, as amended, are annexed to petition as Appendix A.

Statement of Facts

The respondents James L. White, Sara White, Evelyn B. White, Sybil A. White and Cora Benton are the owners of Publicly-Held Bonds of the Fifth Series originally issued by the Prudence-Bonds Corporation, which were guaranteed both as to principal and interest by the Prudence Company, Inc. (predecessor corporation of the petitioner herein) (R. 326). On June 29, 1934, the Prudence-Bonds Corporation filed a petition for reorganization under Section 77b of the Bankruptcy Act (R. 87). There were outstanding at that time eighteen series of first mortgage collateral bonds aggregating in principal amount approximately $56,000,000 (R. 325); each series being

secured by a trust agreement made by the Debtor to a bank as trustee, under which bonds, mortgages, cash and other securities were transferred to the trustee as a trust fund for the security of the bondholders (R. 728).

The Fifth Series was secured by a Trust Agreement dated April 1, 1925, made by the Debtor, Prudence-Bonds Corporation, to the Bank of the Manhattan Company as trustee (R. 90-91). In this series, at the time the Debtor filed its petition, there were outstanding $2,544,300 principal amount of bonds which matured in varying amounts between October 1, 1930 and October 1, 1938, and all of which provided for semi-annual payments of interest at the rate of 5½% per annum (R. 91-92).

On February 1, 1935, the guarantor company, i.e., the Prudence Company, Inc., filed a petition under Section 77b. Thereafter, on April 27, 1937, it was found that the Debtor was insolvent and that the value of the collateral securing each of the eighteen series was less than the principal amount of the outstanding bonds and accrued unpaid interest thereon (R. 815). The Debtor then was reorganized under a plan finally confirmed on May 26, 1939, under which its assets and business were vested in a new company formed under the name of Prudence Realization Corporation (R. 90), the petitioner herein. The plan further provided that the 5½% interest on bonds as originally specified was to be payable if, and only to the extent that, earned income would suffice to pay such interest.

When the Debtor filed its petition, the guarantor company held $1,910,300 principal amount of the Debtor's bonds in varying amounts in each of the eighteen series (R. 93). It held $67,200 in the Fifth Series, and as such claimed equality with the other bondholders of the series, whose bonds had been guaranteed by it. The original plan of reorganization provided that the Court should pass upon this claim, and Section 11 of the original plan further provided that if, irrespective of the provisions of the plan, the Guarantor's bonds were to be determined

on a parity with the Publicly-Held Bonds, they were to be so treated, whereas, if the Public-Held Bonds were awarded priority, the Guarantor's Bonds should not "be entitled to receive any distributions on account of principal until all of the Publicly-Held Bonds have been fully paid, redeemed, purchased or retired". On July 21, 1937, the Court decided that the Guarantor's Bonds were "not entitled to share in the collateral * * * on a parity" with the Publicly-Held Bonds; that the Guarantor's Bonds were "not enforcible obligations either as to principal or interest against their respective trust funds * * *, until" the Publicly-Held Bonds should "have been paid or provided for in full, both as to principal and interest heretofore accrued or hereafter accruing"; and that they should be so entitled "if and when and only after" the Publicly-Held Bonds should "have been paid or provided for in full, both as to principal and interest". The Guarantor Company (the petitioner herein) appealed from this order. The Amended Plan which was drafted before the appeal was disposed of incorporated the alternative possibilities precisely as recited in Section 11 of the original Plan. The appeal was dismissed on January 7, 1938, by virtue of a settlement which accepted the order of July 21, 1937, so far as it fixed the terms of the subordination (R. 95-100); and the Amended Plan was confirmed on January 18, 1938, still, however, without any change in Section 11. The District Court on said date made and entered eighteen orders providing for Amended Plans of Reorganization for each of the series and an Amended General Plan of Reorganization (R. 102). This latter plan provided for the formation of a new corporation to take over the servicing of the collateral underlying all eighteen series (R. 786-787).

It was deemed beneficial for all bondholders to have the underlying collateral of all series administered by one agency so that the various bondholders "should not only preserve for themselves the full value of their own collateral, but by union, they should enable the less fortunate

to be benefited from any excess of collateral of the better issues" (R. 782-784).

On April 27, 1938, a Supplemental Trust Agreement was confirmed which named the City Bank Farmers Trust Company as Trustee of each of the eighteen series and directed the former corporate trustees to turn over all collateral to the new trustee and to file their accountings; and directed the Debtor to transfer all of its rights to the collateral securing the eighteen series (R. 349). Two passages in Article II of the Supplemental Agreement dealt with the subordination of the Guarantor's Bonds: Section 8 declared at its close that they should "not be entitled to share in the Collateral until all other Bonds have been paid or provided for in full according to their tenor"; and Section 10, that they should not "participate in proceeds of the Collateral * * * until the public-owned or held Bonds have been fully paid, purchased or retired by the Corporation".

On September 8, 1938, the Bank of the Manhattan Company, as Trustee under the original trust agreement with the Debtor, filed its account in respect to the Fifth Series (R. 135). Objections were made to this account and the objections were sustained by the District Court on March 28, 1944, and thereafter the Circuit Court affirmed the District Court (R. 139-140). On May 16, 1945, a final judgment was entered against the Bank of the Manhattan Company for $1,472,763.32, with 6% interest from March 28, 1944 (R. 141). The Circuit Court of Appeals in its opinion (*President and Directors of the Bank of the Manhattan Co.* v. *Kelby,* 147 F. (2d) 465) said:

> "The Bank must restore to the fund what was withdrawn from it through the Bank's misconduct. It is against the fund, as it will be when restoration has been made, that the bondholders will assert their claims for the unpaid principal of, and interest on, their bonds. If realization on assets now in the fund, plus the restoration by the Bank, leaves an excess, then of course the Bank will be entitled to the excess."

On May 16, 1945, the Bank of the Manhattan Company paid to the New Corporation $1,572,991.93 in full payment of the judgment for the benefit of the Fifth Series bondholders (R. 147-148). Out of this sum $498,684.55 was allocated to the Income Account, and the balance, after deducting allowances and disbursements, to the Principal Account (R. 149-150).

At the time of the Special Master's Report the Principal Account of the Fifth Series contained $1,349,545.62, less $81,565.14 which the Special Master found had been loaned by the Income Account to the Principal Account and should be restored to the Income Account (R. 149-150). There was then due unpaid principal on the Publicly-Held Bonds $1,077,450 (R. 150). Varying payments have been made on account of interest on the Publicly-Held Fifth Series Bonds, and these payments have been sufficient to pay interest in full at 5½% up to January 19, 1941 (R. 150). As of August 1, 1945, the total deficiency in the payment of interest on the Publicly-Held Bonds of the Fifth Series amounted to $411, 783.18 (R. 159-160). Upon payment in full of the principal of the Publicly-Held Bonds, Fifth Series, the balance remaining in the Principal Account is $190,530.48, in cash, and two mortgages aggregating in face amount $156,968.03 (R. 150-151).

The present litigation involves conflicting claims to this balance remaining in the Principal Account. These claims are:

1. The former trustee (The Bank of the Manhattan Company) claims said surplus by virtue of the opinion of the Circuit Court that any excess was to be returned to it.

2. The petitioner (successor to the guarantor corporation) claims that, pursuant to the Plan and Agreement, the bonds became income bonds for all purposes, and that payment of principal together with payment of income constitutes full payment.

3. The Publicly-Held Bonds assert that there is no surplus until their bonds have been paid in full according to their original tenor, that is, 5½%, as originally guaranteed. It is contended that the restriction of interest to income from the collateral merely affected their right to interest as against the new company during the period of liquidation, but did not impair their ultimate right as lienors upon that collateral for principal and interest in full, i.e., 5½%.

Argument

The petitioner asserts that the Court of Appeals was in error and advances three reasons for granting the writ:

1. The Plan or Agreement as interpreted by petitioner would not be illegal.

While recognizing the basic rule that senior creditors must be paid in full before junior creditors may take anything, petitioner claims that there are exceptions to the general rule, and that the Plan and Agreement in question fall within the exceptions.

2. The plain language of the Plan and Supplemental Trust Agreement indicates that the Publicly-Held Bonds are "fully paid" as to interest when they have received the income earned by the collateral.

3. The effect of holding that Publicly-Held Bonds are entitled to payment in full with interest to the date of payment is to frustrate the pattern of reorganization bargained for among all eighteen series of bonds.

Respondents submit that the Publicly-Held Bonds are entitled to interest at 5½% to date of payment according to their original tenor, that such was the original intention of the Plan and Supplemental Trust Agreement, and that any other interpretation would be unlawful.

1. By virtue of the District Court's decision of July 21, 1937, which held that the petitioner's bonds were not entitled to share in the collateral on a parity with the Publicly-Held Bonds, the latter were entitled to priority as to interest as well as to principal. *Consolidated Rock Co.* v. *DuBois,* 312 U. S. 510, 527, 528; *Institutional Investors* v. *Chicago, M., St. P. & P. R. Co.,* 318 U. S. 523, 546. Furthermore, the priority bondholders are entitled to interest in full until payment. *Coder* v. *Arts,* 152 F. 943, 949, 950 (C. C. A. 8), aff'd 213 U. S. 223, 245; *Ticonic National Bank* v. *Sprague,* 303 U. S. 406. Thus any provision for less than the full 5½% interest until the day of payment would be illegal. Petitioner claims to come within an exception to the foregoing principles to the effect that where the senior position of the creditor is disputed, such a dispute may be compromised by assigning the alleged senior creditor less than full seniority.

Merely to state petitioner's claim clearly in its concrete application to the present circumstances is to refute it. It is claimed that there was a dispute as to whether Guarantor's Bonds were entitled to parity with the Publicly-Held Bonds. This dispute, according to petitioner, was settled by a compromise which gave the Publicly-Held Bonds priority as to principal. As to interest, however, it is claimed the Publicly-Held Bonds accepted earned income on the collateral and surrendered forever and for all purposes any claim to full interest according to the original tenor of the bonds. The facts disclose no such compromise.

The provision of the Supplemental Trust Agreement making the Publicly-Held Bonds "income" bonds was clearly not the result of a compromise of the dispute as to whether or not the Guarantor's Bonds were entitled to parity with the Publicly-Held Bonds. The "income-interest" provision was proposed and accepted not only before the alleged compromise regarding "parity", but in fact antedated the dispute itself. Obviously, such provision did not result from any dispute or compromise of

any dispute. The "income-interest" provision was never in dispute from the beginning of the reorganization! It never was intended by either party at any time to saddle the New Corporation with an obligation to pay a fixed amount of interest during the liquidation. The only dispute between the parties related solely to the question of priority, and the settlement likewise related solely to priority. It cannot be too strongly emphasized that neither had anything to do with the question of whether the Publicly-Held Bonds were to surrender any portion of their full lien on their collateral to the extent of 5½% interest as well as principal.

Furthermore, if the "income-interest" provision had been inserted in the General Plan and the Supplemental Trust Agreement as a compromise, the Plan and the Agreement would have made it unmistakably clear that the provision was a compromise and would have explicitly delineated the rights accruing to the various parties as a result thereof.

Petitioner asserts a second exception to the basic rule that a priority creditor is entitled to interest in full ahead of any payment to junior creditors. It claims, in effect, that the lien of a secured creditor may be cancelled or transferred, provided the creditor receives compensation for his sacrifice. However, the very case cited by petitioner in support of his position, *Institutional Investors* v. *Chicago, M., St. P. & P. P. R. Co.*, supra, makes it quite clear that the compensation must be "full compensation". Clearly, if the Supplemental Trust Agreement was interpreted in the manner petitioner desires, the Publicly-Held Bonds did not receive "full compensation". It is quite true that the Plan need not provide for cash payments to secured creditors and may give them new interests in the corporate property. Such new interests, however, must be equivalent in value to the interests surrendered. *R. F. C.* v. *Denver & R. G. W.*, 328 U. S. 495, 517. In the instant case, no compensation for the alleged sacrifice of the lien for the full 5½% interest has been indicated. The right to share in the surplus collateral of other series, at best, gives the

bondholders what was originally bargained for (i.e., principal plus 5½% interest) and can in no way be deemed compensation for any sacrifice.

It is thus apparent that neither of the so-called corollaries asserted by petitioner have any application to the instant case and therefore the basic rule must prevail. Consequently such a construction of the Plan as would deprive the priority bondholders of their full right would be illegal. Where there is a choice between a lawful construction and one which is unlawful, it is fundamental that the lawful choice (respondent's construction) is to be preferred. *Hobbs* v. *McLean*, 117 U. S. 567, 576; *Great Northern Ry.* v. *Delmar Co.*, 283 U. S. 686, 691; *In re John B. Rose Co.*, 275 F. 409, 415 (C. C. A. 2); *Behre* v. *Anchor Ins. Co.*, 15 F. (2) 380, 383 (C. C. A. 2). In the instant case, moreover, such a choice is plainly in accordance with the intent of the parties as expressed in the language of the Plan.

2. We submit that a reading of the Plan clearly indicates that the sole purpose of providing that the New Corporation was obliged to pay interest only if earned, was to permit the New Corporation to liquidate the collateral in an economic and orderly manner without being saddled with the fixed interest obligation contracted for by the Debtor. There is nothing anomalous in holding that although the Publicly-Held Bonds retained their full lien both as to principal and interest against the collateral and the proceeds from the liquidation of the collateral, the New Corporation would be permitted to liquidate the collateral without being hampered in its program by being under the obligation of making fixed interest payments during the liquidation. Upon completion of the program when the reason for suspending the right of the Publicly-Held Bonds to enforce their lien as to interest no longer exists, there is no reason why the original interest obligation should not be enforced.

The language of the Plan in no way contradicts this point of view. Nowhere in the Plan is ultimate distribution dis-

cussed in any other way but "payment in full as to principal and interest". Nor does the Plan contain any language which can be said to effect any change as far as the original lien of the bondholders on the collateral is concerned. The conclusion cannot be resisted that the Plan did not intend to make, nor did it make, any change in this respect.

Neither did the Supplemental Trust Agreement effect any such change. The relevant provision in Section 77b of the Bankruptcy Act is as follows:

> "Before or after a plan is confirmed, changes and modifications may be proposed therein by any party in interest and may be made with the approval of the judge after hearing upon notice to creditors and stockholders, subject to the right of any creditor or stockholder who shall previously have accepted the plan to withdraw his acceptance, within a period to be fixed by the judge and after such notice as the judge may direct, if, in the opinion of the judge, the change or modification will be materially adverse to the interest of such creditor or stockholder, * * *."

If in fact the Supplemental Agreement did purport to change the Plan in accordance with the manner suggested by petitioner, such a change would obviously be "materially adverse". But said Agreement, approved by the District Court on April 27, 1939, was specifically held not to contain any modification "materially adverse" to the interests of the bondholders.

If, however, the decision of the District Court be construed as holding that the Agreement did modify the Plan as indicated but that such modification was not "materially adverse", such a finding would clearly be an abuse of discretion. Nor would a collateral attack upon the ruling of the District Court, so construed, be precluded at this time by virtue of the doctrine of *res judicata*, as claimed by petitioner. Petitioner's reliance upon *Duggan* v. *Sansberry*, 327 U. S. 499, to the effect that decisions of bankruptcy courts are not subject to collateral attack is wholly mis-

placed. That very case refers to *Kalb* v. *Feuerstein*, 308 U. S. 433, 438, 439, where it is stated:

> "It is generally true that a judgment by a court of competent jurisdiction bears a presumption of regularity and is not thereafter subject to collateral attack. But Congress, because its power over the subject of bankruptcy is plenary, may by specific bankruptcy legislation create an exception to that principle and render judicial acts taken with respect to the person or property of a debtor whom the bankruptcy law protects nullities and vulnerable collaterally."

Section 77b did precisely this. This section, quoted supra, itself specifically conditions the bankruptcy court's power of approval upon the rights of creditors to withdraw upon modification.

It is apparent, therefore, that even if the Supplemental Trust Agreement did purport to modify the Plan, its approval by the Court was wholly void and subject to attack here.

3. Lastly, petitioner asserts that the Court of Appeals assumed that the controversy was solely between the Publicly-Held Bonds and petitioner's bonds, and that they ignored the interest of the other seventeen series in the surplus. Suffice it to say that the Circuit Court of Appeals at the outset of its opinion explicitly stated:

> "We may confine ourselves to the order which directed distribution of the collateral of the Fifth Series; and, indeed even more narrowly, to whether the Publicly-Held Bonds of that series were entitled to interest in full up to the time of payment, as against the bonds in the hands of the Prudence Realization Corporation (the successor of the guarantor of all the bonds), as against any claim of the former trustee (the Manhattan Bank) or as against the New Company itself."

Of course, the interest of the New Corporation was that of the other seventeen series. Accordingly, when the Court of Appeals pointed out that to deprive the Publicly-Held

Bonds of the Fifth Series of interest in full would be "spoliation of the beneficiaries of the trust", it was not unaware of the interest of the other series in the surplus in the Principal Account of the Fifth Series.

The decision of the Court of Appeals does not "frustrate the pattern of reorganization bargained for here". When the reorganization of the eighteen series became necessary, the problems of administering the underlying collateral were enormous. The object as in all such proceedings was as far as possible to make each of the series whole, that is, to return to each series what it had originally contracted for, the principal plus 5½% interest. However, it was foreseen that it was remotely possible that one series might by reason of a "windfall" find itself in the position not only of being made whole, but actually receiving a greater return than bargained for. We submit that it was for the sole purpose of avoiding such an eventuality that provision was made in the Supplemental Trust Agreement that if there should be any surplus after all the bonds in any series had been retired, such surplus should be distributed among the remaining series. But since, as to the Fifth Series, the funds are insufficient to pay the bonds in full with interest to the date of payment in accordance with their original tenor (i.e., to make them whole), it would be manifestly inequitable to turn over any of the Fifth Series funds to the other seventeen series.

WHEREFORE, it is respectfully requested that the petition for a writ of ceriorari be denied.

Respectfully submitted,

FRANK L. WEIL,
Attorney for Respondents,
James L. White, etc.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1947

No. 572

PRUDENCE REALIZATION CORPORATION,
Petitioner,

v.

GEORGE E. EDDY, et al.

BRIEF FOR PRUDENCE-BONDS CORPORATION (NEW CORPORATION) AND FOR TRUSTEE OF DEBTOR IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

Opinions Below

The opinion of the Circuit Court of Appeals for the Second Circuit is not yet reported, but is printed in the Record at pages 614-623.

The opinions of the District Court are unreported, but are printed at R. 22-27, 479.

The Reports of the Special Master are also unreported, but are printed at R. 28-72, 575-602.

Jurisdiction

The decree of the Circuit Court of Appeals was entered on December 8, 1947 (R. 623). Petitions for rehearing filed in that Court by the petitioner and by Reconstruction

Finance Corporation were denied on January 5, 1948 (R. 650). The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended, 28 U. S. C. A. Sec. 347(a), and Section 24(c) of the Bankruptcy Act, as amended, 11 U. S. C. A. Sec. 47(c).

Statement

The issues decided by the Circuit Court of Appeals arose on four petitions to the Bankruptcy Court for instructions with respect to the distribution of Trust Fund collateral under the provisions of confirmed Plans of Reorganization and a Supplemental Trust Agreement approved by the Bankruptcy Court to carry out the Plans (R. 106-184, 427-477, 490-500, 530-542). Three of the petitions were filed by Prudence-Bonds Corporation, the New Corporation formed pursuant to the Plans of Reorganization (R. 108, 492, 532). The other petition was filed by City Bank Farmers Trust Company, Trustee under the Supplemental Trust Agreement (R. 429).

The decision of the Circuit Court of Appeals determines not only a dispute between the Publicly Held Bonds on the one side and the subordinated bonds on the other, but also the question among all eighteen Series of bonds, as to when collateral in a Series becomes surplus or excess available for pro rata distribution among the remaining Series of bonds outstanding at the time.

The Circuit Court of Appeals held that the bonds, as modified by the Plans, are not strictly income bonds on which interest is payable only out of the Net Income from the Trust Fund collateral, but that upon payment of the principal of the Publicly Held Bonds of a Series the net proceeds of all collateral remaining in the Trust Fund securing the Series are to be used to pay deficiencies of interest at the original rates borne by the bonds (R. 644). A Special Master and the Bankruptcy Court Judge in charge of the reorganization had held that the reorganized bonds were income bonds on which interest was payable

only out of the net income from the collateral, and that the net proceeds of the collateral remaining after payment of the principal of the Publicly Held Bonds were to be used to pay the principal of the subordinated bonds of the Series, and that any balance of collateral then remaining was distributable as principal pro rata among the remaining Series of Bonds outstanding at the time (R. 8-72).

Collateral which, under the decision of the Bankruptcy Court, would have been surplus available for payment of the principal of the subordinated bonds and for pro rata distribution as principal among all Series will, under the decision of the Circuit Court of Appeals, be applicable to pay deficiencies of interest on the bonds of those Series in which the collateral will liquidate for more than the principal amount of the Publicly Held Bonds. The decision of the Circuit Court of Appeals, therefore, adversely affects not only the petitioner, as holder of the subordinated bonds, but also numerous holders of bonds of those Series which will show a deficiency of principal.

In the Courts below, respondents the new Prudence-Bonds Corporation and the Trustee of the Debtor took no position on the issues decided by the Circuit Court of Appeals since they represent all eighteen Series of bonds. The issues, however, are of a novel character and of substantial importance in the administration of the Bankruptcy Act and to thousands of widely scattered holders of the Debtor's bonds and we, therefore, respectfully urge that the petition be granted.

Respectfully submitted,

CHARLES M. MCCARTY,
Counsel for Prudence-Bonds Corporation (New Corporation).

GEO. C. WILDERMUTH,
Counsel for Trustee of Debtor.

February 25, 1948.

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IN THE

Supreme Court of the United States

October Term 1947
No. 572

PRUDENCE REALIZATION CORPORATION,
Petitioner,

v.

GEORGE E. EDDY, *et al.*

BRIEF FOR PRUDENCE BONDHOLDERS IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

JOSEPH NEMEROV,
Counsel for Hilda S. Reese, et al., bondholders.

IN THE

Supreme Court of the United States

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Jurisdiction

The decree of the Circuit Court of Appeals was entered on December 8, 1947 (R. 623). Petitions for rehearing filed in that Court by the petitioner and by Reconstruction Finance Corporation were denied on January 5, 1948 (R. 650). The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended, 28 U. S. C. A. Sec. 347(a), and Section 24(c) of the Bankruptcy Act, as amended, 11 U. S. C. A. Sec. 47(c).

Statement

The issues decided by the Circuit Court of Appeals arose on four petitions to the Bankruptcy Court for instructions with respect to the distribution of Trust Fund collateral under the provisions of confirmed Plans of Reorganization and a Supplemental Trust Agreement approved by the Bankruptcy Court to carry out the Plans (R. 106-184, 427-477, 490-500, 530-542). Three of the petitions were filed by Prudence-Bonds Corporation, the New Corporation formed pursuant to the Plans of Reorganization (R. 108, 492, 532). The other petition was filed by City Bank Farmers Trust Company, Trustee under the Supplemental Trust Agreement (R. 429).

The Circuit Court of Appeals ostensibly deciding a dispute between publicly held bonds on the one hand and subordinated bonds on the other, went far beyond that, and, by its decision, additionally affected the rights of public bondholders which they then had under the aforesaid plans of reorganization in that said bondholders have been

deprived of the right to share in any surplus or excess that may become available under the said plans of reorganization for pro rata distribution among the remaining series of bonds outstanding at the time.

The Bankruptcy Court affirmed the Special Master in holding that the bonds of each series, under the said plans of reorganization were to be income bonds, that is, interest on said bonds was to be payable out of the net income derived from the collateral of each series; that any proceeds remaining after the payment of the principal of the publicly held bonds of each series were to be used to pay the principal of the subordinated bonds of said series; that any balance remaining was to be distributed as principal pro rata among the publicly held bonds of the remaining series which were outstanding at that time (R. 8-72).

The Circuit Court of Appeals reversed the court below to the extent of holding that the proceeds remaining after the payment of the principal of the publicly held bonds should be used not to pay the principal of the subordinated bonds of that series, but should be used for the purpose of paying to the publicly held bondholders of that series the deficiencies of interest as fixed in the original bonds prior to the consummation of the said plans of reorganization. In other words, the Circuit Court of Appeals disregarded the provisions of the said plans of reorganization which changed said bonds from fixed interest bonds to income bonds. By reason of the decision of the Circuit Court of Appeals the publicly held bonds of all the series became affected as we have hereinabove shown. The undersigned represents public bondholders of all of the eighteen series most of whom are adversely affected by the decision of the Circuit Court of Appeals.

We respectfully urge that the issues involved herein are of substantial importance to the numerous holders of publicly held bonds of the various series, and we therefore respectfully pray that the petition for writ of certiorari be granted.

Respectfully submitted,

JOSEPH NEMEROV,
Counsel for Hilda S. Reese, et al., bondholders.

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IN THE

Supreme Court of the United States

OCTOBER TERM 1947

No. 572

PRUDENCE REALIZATION CORPORATION,
Petitioner,

v.

GEORGE E. EDDY, ET AL.

MEMORANDUM OF THE RESPONDENT, RECONSTRUCTION FINANCE CORPORATION, IN SUPPORT OF PETITION FOR CERTIORARI

Jurisdiction

The decree of the Circuit Court of Appeals was entered on December 8, 1947 (R. 623). Petitions for rehearing filed in that Court by the petitioner and by Reconstruction Finance Corporation were denied on January 5, 1948 (R. 650). The petition for certiorari was filed on February 4, 1948. The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended, 28 U. S. C., Sec. 347(a), and Section 24(c) of the Bankruptcy Act, as amended, 11 U. S. C., Sec. 47(c).

Statement

This memorandum is submitted by the respondent, Reconstruction Finance Corporation (hereinafter called RFC), in support of the petition for certiorari in this case.

The respondent RFC is an intervenor in this bankruptcy proceeding. Its interest in the present litigation is two-fold:[1]

The RFC has a participation, as a creditor, of approximately 16% in the assets of the petitioner. Among these assets, which petitioner is liquidating for the benefit of the creditors of The Prudence Company, Inc., are subordinated bonds of the Debtor in the unpaid original principal amount of $1,910,300. These bonds have been rendered substantially worthless by the decision below that the unsubordinated or publicly held bonds of each Series are not income bonds as to their lien against the collateral of that Series, but are also entitled to interest at the rate originally borne by the bonds before reorganization, even though such interest was unearned by the collateral.

In addition, RFC's wholly-owned subsidiaries (acquired through foreclosure of collateral in connection with its loan to The Prudence Company, Inc.) and other corporations in which it has financial interests are the beneficial owners of unsubordinated or publicly held bonds having $203,856 of unpaid principal (originally in the principal amount of $568,700), including bonds in various Series in which the collateral is insufficient to pay the full principal. The plan of reorganization gave to such bonds the

[1] As part security for a defaulted loan of $20,000,000 to The Prudence Company, Inc., RFC also held as pledgee all the Debtor's stock. Under the Plan, RFC had the right to purchase a subordinate class of stock in the reorganized company (R. 251, 157). Through its wholly-owned subsidiaries and other corporations in which it has financial interests, RFC also presently has an interest in 11,391-8/10 shares out of a total of 113,000 of the stock of the Prudence Bonds Corporation.

right to share in surplus collateral of other Series (R. 155). The benefit of this provision, however, has been destroyed by the decision below that the publicly held bonds are entitled to interest at the rate originally borne by them, since the allowance of the claim for such interest is sufficient to prevent the existence of surplus collateral in any Series.

It is important to note that the opinion of the Court of Appeals failed to mention this latter dispute among the unsubordinated or publicly held bonds of the several Series, and the fact that its decision will give approximately $775,000 in additional interest payments over and and above the interest earned on the collateral to publicly held bonds of some Series to the exclusion of payments on account of principal to a greater number of publicly held bonds of other Series (Petition, p. 25). Instead the Court erroneously treated the case as a contest wholly between subordinated and unsubordinated or publicly held bonds in each Series (R. 615).

The existence of approximately 3½% of subordinated bonds [2] was thus sufficient to frustrate the reciprocal rights of the publicly held bonds to share in surplus collateral. These rights were part of a plan which was designed to conserve and recoup the principal of the bonds, even at the expense of interest, and which was initiated when the ultimate value of the collateral was unascertainable.

Indeed, the pattern of the reorganization was fixed before the subsidiary issue of subordination was determined. The Plan provided for income bonds, and reserved the question of whether petitioner's bonds should be subordinated to the publicly held bonds. When this disputed issue was compromised no change was made in the Plan. The guarantor's bonds merely took their subordinated place in the general reorganization scheme.

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[2] The Debtor had outstanding approximately $56,000,000 of bonds (R. 109), of which $1,910,300 were subordinated bonds (Petition, p. 25).

The respondent, RFC, believes that the decision of the Court of Appeals in this case was based upon erroneous concepts of law, and that the petition for certiorari raises substantial questions of bankruptcy law which should be reviewed here. Accordingly, for the reasons set forth in the petition for certiorari, the respondent, RFC, urges that the petition be granted.

Respectfully submitted.

JAMES L. DOUGHERTY,
General Counsel

JAMES F. DEALY,
Special Counsel

E. A. STANSFIELD,
Assistant General Counsel

EDWARD L. FRIEDMAN, JR.,
Of Counsel

Reconstruction Finance Corporation

The filing of this memorandum is authorized.

February 26, 1948.

PHILIP B. PERLMAN, Solicitor General